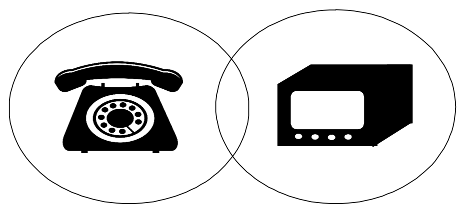
WHITE PAPER

THE CABLE-TELCO DUOPOLY'S DEPLOYMENT OF NEW JERSEY'S INFORMATION INFRASTRUCTURE: ESTABLISHING ACCOUNTABILITY



prepared for the

Public Advocate of New Jersey

Division of Rate Counsel

by

Susan M. Baldwin

Sarah M. Bosley

Timothy E. Howington

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PREFACE

The New Jersey Division of Rate Counsel submits this paper to contribute affirmative recommendations to assist the New Jersey Board of Public Utilities in establishing cable franchise regulations that protect consumers of noncompetitive telecommunications and cable services from subsidizing Verizon's and the cable industry's entry into new lines of business.[1] Carefully constructed safeguards will yield just and reasonable rates for basic cable and basic telecommunications services and will also support the continuing evolution of a sophisticated information infrastructure for the state of New Jersey. Also, by deterring improper cross-subsidization, safeguards will contribute to the establishment of accurate pricing signals, and, therefore, to the economically efficient deployment of investment throughout the state by suppliers that compete on an equal footing.

Structural separations, whereby the company's business segments providing noncompetitive services operate separately from those business segments that provide competitive offerings, are critically important in those instances in which the economies of scope are such that firms use substantial amounts of common network plant investment and common resources to support noncompetitive, regulated *and* (purportedly) competitive, unregulated services. The benefit of structural safeguards to today's consumers is that, if implemented and enforced adequately, consumers of regulated services will not subsidize unregulated services. Therefore, rates will be lower than they otherwise would be, and, furthermore, will correspond more accurately with the underlying costs of providing those regulated services. As incumbent local exchange carriers increasingly derive revenues from unregulated services, and as they venture into new lines of business such as FiOS and video services, structural safeguards are increasingly important. Absent adequate safeguards, consumers could end up footing the bill for Verizon's pursuit of video subscribers and its development of other unregulated offerings. Similarly, customers of basic cable services are at risk of subsidizing cable companies' entry into new markets. Structural safeguards are particularly important as a result of the enactment of the recent statewide cable-franchise bill, which streamlines Verizon's entry into New Jersey's cable markets.

Structural safeguards also benefit future consumers. First, they minimize the opportunity for undetected subsidization of unregulated services with revenues derived from regulated services and for carriers' exertion of their market power, and thereby minimize anti-competitive consequences in the market. A competitive market will yield greater diversity in service offerings, lower rates, and higher service quality than would otherwise ensue. Second, if in the future, carriers' attempts to enter new markets prove unprofitable, adequate safeguards will prevent future generations of consumers from footing the bill for business plans gone awry.

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[1]/ The authors, Susan M. Baldwin, Sarah M. Bosley, and Timothy E. Howington, consult to public sector agencies on the economics, policy, and regulation of telecommunications.

EXECUTIVE SUMMARY

The Board's cable regulations should encompass adequate consumer protection against improper cross-subsidization.

Recent legislation has altered dramatically the converging cable-telecommunications ("cable-telco") market in New Jersey by facilitating Verizon New Jersey's entry into cable markets. As directed by the statute, the New Jersey Board of Public Utilities is developing cable television regulations, which will affect consumers throughout the state, and which will guide Verizon New Jersey's and cable companies' entry into each other's traditional markets.

As the telco and cable industry seeks to garner market share in the triple play (voice, data, and video) and quadruple play (triple play plus wireless) bundled services markets, customers of basic telephone and basic cable service are at serious risk of improperly bearing the cost and risk of the industry's forays into new markets. The consequences for basic service consumers are excessive rates and deteriorating service quality.

Telecommunications and cable companies in New Jersey have the ability and the incentive to subsidize their new lines of business with their noncompetitive ones.

Telecommunications and cable companies have the ability and the incentive to subsidize their pursuit of new markets with their noncompetitive operations and services. There is insufficient competition in either cable or telco markets to protect consumers from bearing the cost and risk of companies' entry into non-traditional markets. Verizon New Jersey controls 97% of the local lines in its territory either directly with its retail service or indirectly with its wholesale service. Despite industry-generated hype, intermodal alternatives do not constrain the incumbent carriers in the wireline market.

Cable companies continue to raise rates and although, theoretically, they can compete, in fact, the incumbents continue to serve non-overlapping territories. The semblance of competition in the converging cable and telecommunications industries is misleading. A cable-telco duopoly controls 98 percent of the nation's broadband connections to the Internet, and, therefore, dominates the state's "pipes" over which households and businesses make telephone calls, access the Internet, locate information, conduct business, and obtain entertainment.

Telecommunications and cable companies each rely on substantial shared and common networks, overhead, expertise, and other common resources to offer both traditional and new services to New Jersey consumers. This large amount of joint and common resources facilitates improper cross-subsidization.

Improper cross-subsidization harms consumers.

The New Jersey Telecommunications Act of 1992[2] prohibits the subsidization of competitive services with revenues derived from noncompetitive services. The Legislature stated that "[n]o local exchange telecommunications company may use revenues earned or expenses incurred in conjunction with noncompetitive services to subsidize competitive services."[3] Improper cross-subsidization harms consumers. When cross-subsidization occurs, companies charge excessive rates for regulated, noncompetitive services and divert resources toward new lines of business, jeopardizing the quality of basic services. Also, anticompetitive cross-subsidization thwarts emerging competition, which, in turn, denies consumers the benefit that a sufficiently competitive market would otherwise offer. Finally, improper cross-subsidization yields rates that are not aligned with costs: these inaccurate pricing signals lead to market distortions in the supply of and demand for telecommunications and cable services.

Under today's deregulatory paradigm, where true competition has not yet arrived, but new services are unregulated, consumers are vulnerable to two distinct harms as the incumbent telephone companies roll out new technology: (1) some consumers will be left behind as the telco-cable duopoly races to attract and to lock in high-revenue customers; and (2) precisely those consumers who are left behind will be forced to subsidize new services.

As Verizon moves into new lines of business, including broadband and video markets, it is essential to ensure that basic noncompetitive services are not subsidizing these new services. It is also essential to ensure that Verizon does not neglect the more "mundane" responsibilities of installing and repairing basic telephone service in a timely manner. Verizon's service quality has been declining in New Jersey, as measured by the time required to repair telephone service. Similarly, in New York, where Verizon has also been rolling out its new FiOS, Verizon's service quality has also been deteriorating.

Existing federal and state policies do not protect consumers adequately.

Although federal legislation[4] and state legislation[5] prohibit improper cross-subsidization, adequate safeguards are essential to deter and to detect such cross-subsidization. The Board lacks the necessary tools to ensure compliance and, furthermore, has not yet established the requisite incentives to encourage proper cost accounting. Therefore, the Board should ensure that its final cable regulations require

[2] / N.J.S.A.: 48:2-21.16 *et seq.* ("1992 New Jersey Act").

[3] / N.J.S.A.: 48:2-21.18.c.

[4] / Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 ("1996 Act"), Section 254(k). The 1996 Act amended the Communications Act of 1934. Hereinafter, the Communications Act of 1934, as amended by the 1996 Act, will be referred to as "the 1996 Act," or "the Act," and all citations to the 1996 Act will be to the 1996 Act as it is codified in the United States Code.

[5] / 1992 New Jersey Act.

structural separations, include adequate accounting and non-accounting safeguards, and establish timetables for audits.

The Board should impose structural separations to ensure that the state's information infrastructure evolves in an economically efficient manner.

In a world in which companies increasingly integrate and promote "bundles" of diverse technologies, requirements for accounting and accountability may seem arcane. Indeed, if the product market were competitive, that is, if there were no dominant carriers capable of exerting market power, proposals for accounting and structural separations, and many other regulatory proposals, would be superfluous. However, as this paper demonstrates, a number of the underlying components of the product bundles that Verizon, Cablevision, Comcast, and other cable companies advertise and sell are not yet sufficiently competitive.

Therefore, the Board should require incumbent telecommunications and cable carriers to furnish their regulated services separately from their unregulated ones. Furthermore, the Board should establish the necessary accounting and non-accounting safeguards to protect consumers and competitors from improper cross-subsidization.

Safeguards are entirely compatible with the development of an advanced information infrastructure for New Jersey.

Regulatory safeguards are consistent with New Jersey's pursuit of an advanced information structure. They will further the goal of ensuring that carriers establish rates that correspond with costs, yielding pricing signals that contribute to the economically efficient supply of services throughout the state. Regulatory safeguards will also ensure that, in its FiOS-based pursuit of cable customers, Verizon does not ignore all of the basic telephone service customers who either do not have the FiOS option available to them, or decide not to avail themselves of the new option. The timely installation and repair of plain, copper-based dial tone lines is essential to provide New Jersey's households and businesses with reliable access to emergency services, the economic mainstream, and other elements of the state's societal infrastructure.

Furthermore, as Verizon embarks on its ambitious FiOS network, households and businesses in rural communities may continue to lack access to copper-based DSL. The fact that consumers throughout the state, through their basic telephone rates, have financed a ubiquitous copper network, yet cannot even avail themselves of DSL should cause concern for state policy makers. The potential for unfair and uneven access to the state's information infrastructure warrants review. Some residents and businesses will be able to use FiOS for broadband speeds of 5 Mbps to 30 Mbps while other customers must use dial-up to access the Internet.

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1. INTRODUCTION

1.1. Consumers have a stake in telco-cable market convergence.

Technological innovation and advanced services deployment, which the merging of the historically separated video and telephone markets are yielding, may lead to widespread benefits for consumers throughout New Jersey. As lines between voice, data, and video blur, as cable companies increasingly enter traditional telephone company turf and telecommunications companies increasingly enter traditional cable turf, [6] and as companies design and offer new products and services, consumers are enjoying novel and sophisticated ways to obtain and to deliver information for, among other things, work, entertainment, health, public safety, and education. However, as this paper demonstrates, inadequate competition in the provision of information "pipes" to New Jersey homes and businesses jeopardizes just and reasonable rates for basic telecommunications and basic cable services (as well as for "triple" or "quadruple" play bundles).[7] The lack of broadband and narrowband competition, combined with the substantial sharing of joint and common plant utilized to offer traditional, noncompetitive and new lines of business presents significant opportunities for anti-competitive cross-subsidization.[8]

Therefore, adequate safeguards are essential to protect consumers' interests and to ensure that competition can evolve efficiently and fairly as cable and telecommunications companies offer integrated voice and video services. Preventing improper cross-subsidization will promote efficient deployment of resources by businesses and is compatible with a vision of an advanced information infrastructure for the state of New Jersey.

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[6] / On August 4, 2006, Governor Corzine signed cable franchise legislation A-804/S-192. State of New Jersey Office of the Governor, Press Release, "Governor Corzine Signs Cable Franchise Legislation and Executive Order," August 4, 2006. On November 2, 2006, Verizon filed the first systemwide cable franchise in New Jersey (Verizon New Jersey, Inc. *Application for a Systemwide Cable Franchise*, November 2, 2006, ("Verizon Franchise Application"). The Board approved Verizon's application and granted Verizon a systemwide cable television franchise on December 18th, 2006 (*In the Matter of the Application by Verizon New Jersey, Inc. for a Systemwide Cable Television Franchise*, New Jersey Board of Public Utilities Office of Cable Television Docket No. CE06110768, *Order*, December 18, 2006 ("Verizon Systemwide Cable Television Franchise Order")).

[7] / "Triple play" refers to bundles of voice, data, and video services. "Quadruple play" refers to bundles of voice, data, video, and wireless services.

[8] / Cross-subsidization refers to the use of revenues and resources from one line of business to fund initiatives in another line of business. In this paper, cross-subsidization refers to the use of revenues and resources derived from the traditional, regulated and noncompetitive portions of the carriers' business to fund new, unregulated initiatives.

INTRODUCTION

It is in Verizon New Jersey Inc.'s ("Verizon")[9] and the cable industry's financial interest to attempt to persuade the Board of Public Utilities ("Board") of the myth that regulation will stymie technological advancement, and that by asserting its authority to oversee Verizon's and the cable industry's accounting for its new ventures, the Board will hinder the deployment of an advanced information infrastructure in New Jersey. Regional Bell operating companies ("Bells" or "RBOCs") throughout the country used precisely this line of argument during the 1990s and early 2000s to obtain regulatory freedoms in exchange for unenforceable and rarely fulfilled promises to deploy state-of-the-art technology.[10] A more rational regulatory future will reject any potential infrastructure scare tactics (where carriers threaten to hold hostage new technology if regulators seek to look too closely at their cost accounting and affiliate transactions), and will not barter away consumer protections for phantom promises.

Properly designed regulation will serve as the catalyst for economically efficient pricing signals for both old and new services. In turn, these accurate pricing signals will yield an efficient allocation of society's resources that corresponds with consumers' demand for old and new services. Absent such intervention, marketplace distortions (driven in large part by the industries' incentive and ability to subsidize competitive ventures with their noncompetitive offerings) will result in misleading pricing signals that do not correspond with underlying costs and that, therefore, will not yield the efficient supply of services to consumers and businesses throughout the state. If Verizon and the cable industry truly consider it profitable to enter each other's traditional lines of business, based on fair accounting of the costs to pursue such businesses, these financial incentives should prevail in the presence of regulatory safeguards that ensure that noncompetitive services do not subsidize competitive ones.

Furthermore, as Verizon embarks on its ambitious FiOS network, which is expected to pass half the households it serves nationwide by 2010,[11] households and businesses in rural communities may continue to lack access to copper-based DSL

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[9] / This paper refers to Verizon New Jersey, Inc. as Verizon or Verizon NJ. When the discussion includes Verizon New Jersey's parent company, Verizon Communications, Inc., the company is referred to as Verizon Communications.

[10] / For example, in 1992, New Jersey Bell's (now Verizon NJ) original petition for an alternative form of regulation indicated that "the plan would enable NJ Bell to invest in the accelerated deployment of advanced switching and transmission technologies for its communications network." *In the Matter of the Application of New Jersey Bell Telephone Company for Approval of Its Plan for an Alternative Form of Regulation*, Docket No. T092030358, May 6, 1993 ("PAR-1 Order"), at 1. The Board approved New Jersey Bell's plan, with modification, "conditioned upon a commitment by NJ Bell to achieve ONJ [Opportunity New Jersey] in its entirety, including full broadband capability by the year 2010." *Id.*, at 97. ONJ remains incomplete and warrants the Board's review.

[11] / Thomson StreetEvents, Conference Call Transcript, Verizon FiOS Briefing Session, Sept. 27, 2006 ("Verizon FiOS Briefing Session"), at 4.

service.[12] The fact that consumers throughout the state, through their basic telephone rates, have financed a ubiquitous copper network, yet cannot even avail themselves of DSL should cause concern for state policy makers. The technological leapfrogging of some communities over rural ones will create unfair and uneven access to the state's information infrastructure, which merits Board review. Some residents and businesses will be able to use FiOS for broadband speeds of 5 Mbps to 30 Mbps while other customers must use dial-up to access the Internet.

This paper was prepared on behalf of the New Jersey Division of Rate Counsel ("Rate Counsel"). The Rate Counsel's responsibility is to ensure that all classes of utility consumers receive safe, adequate and proper utility service at affordable rates that are just and nondiscriminatory.[13]

1.2. Purpose of paper.

The purpose of this paper, prepared on behalf of Rate Counsel, is to provide a factual foundation and economic principles to guide the Board's development of policy and regulation to address the telecommunications and cable industries' use of common plant and resources to offer competitive and noncompetitive services. This paper demonstrates that there is insufficient competition in the overlapping telecommunications and cable markets to yield just and reasonable rates and adequate service quality.

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[12] / In New Jersey, 88% percent of residential end-user premises where ILECs offer local telephone service have xDSL availability. Industry Analysis & Technology Division, Wireline Competition Bureau, Federal Communications Commission, *High-Speed Services for Internet Access: Status as of December 31, 2005*, July 2006 (Data as of December 31, 2005) ("FCC High-Speed Services July 2006 Report"), at Table 14. Because rural communities have small populations, they do not comprise a significant percentage of total households in New Jersey, but likely comprise the vast majority of the underserved regions of the state. Verizon's focus on its FiOS operations and away from rural operations is evidenced more recently by its sale of its telephone business in Maine, New Hampshire, and Vermont. "Verizon to Sell Phone Assets to FairPoint in 3 States," *The New York Times,* C4, January 17, 2007.

[13] / Effective July 1, 2006, the New Jersey Division of Ratepayer Advocate is now the New Jersey Division of Rate Counsel. The Rate Counsel, formerly known as the New Jersey Ratepayer Advocate, is a Division within the Department of the Public Advocate. The Department of the Public Advocate is a government agency that gives a voice to New Jerseyans who often lack adequate representation in our political system. The Department of the Public Advocate was originally established in 1974, but it was abolished by the New Jersey State Legislature and New Jersey Governor Whitman in 1994. The Division of the Ratepayer Advocate was established in 1994 through enactment of Governor Christine Todd Whitman's Reorganization Plan. The mission of the Ratepayer Advocate is to make sure that all classes of utility consumers receive safe, adequate and proper utility service at affordable rates that are just and nondiscriminatory. In addition, the Ratepayer Advocate works to insure that all consumers are knowledgeable about the choices they have in the emerging age of utility competition. The Department of the Public Advocate was reconstituted as a principal executive department of the State on January 17, 2006, pursuant to the Public Advocate Restoration Act of 2005, P.L. 2005, c. 155 (*N.J.S.A*. §§ 52:27EE-1 et seq.). The Department is authorized by statute to "represent the public interest in such administrative and court proceedings . . . as the Public Advocate deems shall best serve the public interest," *N.J.S.A.* § 52:"27EE-57, *i.e.*, an "interest or right arising from the Constitution, decisions of court, common law or other laws of the United States or of this State inhering in the citizens of this State or in a broad class of such citizens." N.J.S.A.§52:27EE-12, and the office of the Rate Counsel, formerly known as the Ratepayer Advocate, became a division therein to continue its mission of protecting New Jersey ratepayers.

Therefore, regulatory intervention is essential to protect consumers from monopoly practices and cross-subsidization; to enable emerging competition to evolve in telecommunications and cable markets; and to identify those markets which, absent regulatory directives, will not be served adequately because the probable costs exceed the probable revenues.

The Board's regulations should require structural separations, whereby Verizon's venture into FiOS and video lines of business are offered from an affiliate that is separate from its traditional telecommunications business[14] and whereby the cable industry's venture into telecommunications is offered from an affiliate that is separate from its basic cable service offerings. Structural separations are essential to protect today's generation of consumers from improper cross-subsidies. Structural separations are also essential to protect future generations of consumers from footing the bill for any FiOS plans that go awry. If the Board does not impose structural safeguards, it should adopt a comprehensive system of non-structural safeguards.

The Board seeks comment on its proposed cable rules.[15] The purposes of this paper are to contribute to the discussion about those proposed rules and also to offer specific recommendations. The paper's analysis and proposals are intended to encourage the evolution of an advanced information infrastructure in New Jersey that meets consumers' demand, and that is priced in a way that recovers a fair and economically efficient portion of the industry's shared and common costs.

1.3. Organization of paper.

The following chapter, Chapter 2, demonstrates that the cable and telecommunications industries have the ability to engage in improper cross-subsidization. Chapter 2 also analyzes and describes the implications of a duopoly for consumers.

Chapter 3 describes how incumbent cable and telecommunications companies have the incentive to engage in cross-subsidization. Chapter 4 discusses generally the existing federal and state policy vis-à-vis cross-subsidization, and demonstrates that it is not sufficient to protect consumers. Chapter 5 sets forth the Rate Counsel's recommendation, and Chapter 6 concludes the main portion of this paper. Also included with this paper are several appendices which provide detailed data and information pertinent to the issues this paper encompasses.

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[14]/ References are made to Verizon throughout because Verizon is the primary incumbent local exchange provider in New Jersey and it sought and received a systemwide cable franchise. Embarq Corporation, formerly United Telephone Company (the Local Telecommunications Division of Sprint), served approximately 205,441 switched access lines in 2005 as an incumbent in New Jersey. Verizon New Jersey served approximately 5,414,559 switched access lines in 2005. FCC ARMIS Report 43-08, Table II. Switched Access Lines in Service.

[15] / *In the Matter of the Board's Regulations of Cable Television, Proposed Readoption with Amendments and New Rules: N.J.A.C. 14:18-14 and 15,* Verizon BPU Docket Nos. CX06030141 and CX06080580, Proposal Number: PRN 2006-384 ("Proposed Regulations").

1.4. Overview of relevant markets.

This paper focuses on the New Jersey telecommunications ("telco") and cable markets, but also analyzes national market and regulatory trends as well as Verizon and national cable industry corporate-level strategies and practices because they influence New Jersey's market. To the extent available, data specific to New Jersey's market are provided, and these data are supplemented by national data. Although New Jersey is ahead of other states from the perspective of cable franchising, the emergence of a cable-telco duopoly and the convergence of voice, data, video, and wireless is occurring throughout the nation.

2. INCUMBENT CABLE AND TELECOMMUNICATIONS COMPANIES HAVE THE ABILITY TO ENGAGE IN IMPROPER CROSS-SUBSIDIZATION

2.1. Background.

The current state of competition and regulation does not sufficiently deter cross-subsidization and protect consumers. This chapter explains why the Board cannot rely on either the level of competition in today's cable[16] and telco markets or on price cap regulation to protect consumers from improper cross-subsidization. Contrary to the unfounded Bell myth, the Bells' dominant position has not yet diminished sufficiently to enable regulators to rely on competitive forces to yield economically efficient rates. This chapter and Chapter 3 demonstrate that Verizon and cable companies possess the ability and the incentive to subsidize their new lines of business with their noncompetitive lines of business.

A myth often perpetuated by the Bells, including Verizon Communications, is that adherence to the Federal Communications Commission's ("FCC" or "Commission") accounting separations and cost allocation rules is irrelevant in today's purportedly competitive environment.[17] Another myth propounded by the Bells is that the presence of price cap regulation makes cost accounting irrelevant. This chapter rebuts both myths.

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[16] / Comcast and Cablevision serve approximately 90 percent of the total 2.5 million New Jersey subscribers in primarily non-overlapping geographic markets at the end of 2005. Comcast serves approximately 1,366,279 customers and Cablevision serves 963,576 customers. New Jersey Board of Public Utilities, Office of Cable Television, *Cable Facts 2006*, at 18.

[17] / The FCC is currently investigating options for reform of its accounting separations regime in FCC CC Docket No. 80-286. *In the Matter of Jurisdictional Separations and Referral to the Federal-State Joint Board*, FCC CC Docket No. 80-286, *Order and Further Notice of Proposed Rulemaking*, Rel. May 16, 2006 ("FCC Separations FNPRM"). The Rate Counsel is participating in the FCC's investigation. *See*, *e.g.,* Comments of the National Association of State Utility Consumer Advocates, the New Jersey Division of Rate Counsel and the Maine Office of the Public Advocate in CC Docket No. 80-286, August 22, 2006 and Reply Comments of the National Association of State Utility Consumer Advocates, the New Jersey Division of Rate Counsel and the Maine Office of the Public Advocate in CC Docket No. 80-286, November 20, 2006. The jurisdictional separations process determines the manner in which ILECs apportion regulated costs among jurisdictions (*i.e.,* interstate and intrastate jurisdictions). In conducting the jurisdictional separations process, carriers first assign the regulated cost of categories of plant and expenses (and sometimes among services with those categories). Carriers then allocate the costs in each category to the intrastate or interstate jurisdiction based upon: a relative use factor, a fixed allocator, or, by direct assignment (when allowed by Part 36 rules). 47 C.F.R. Part 69. Separations bears directly on regulators' ability to detect improper cross-subsidization particularly as carriers use extensive common network and resources to enter unregulated lines of business. These rules are discussed in more detail in Chapter 4.

2.2. Sufficient competition does not yet exist to constrain incumbents' market power.

In its proposed cable rules, the Board characterizes Verizon's position regarding the need for regulatory oversight in the following manner:

> Where there is competition in a market, Verizon states, artificial regulatory requirements are unnecessary and undesirable. Unnecessary, Verizon contends, because competitive forces act as an unseen guide that efficiently allocate resources and spur companies to lower prices, provide improved service quality and offer new and innovative products and services; and undesirable because they can increase the cost of market entry and discourage market entry by new providers.[18]

According to this line of reasoning, separations and cost allocation rules are irrelevant in today's purportedly competitive environment: the market place yields efficient, competitively established rates, and, therefore, cost accounting is an unnecessary burden on industry and regulators.[19] The fundamental fallacy in the Bells' arguments is that competitive forces do not yet exist to constrain the price of Verizon's (or cable companies') basic services nor does competition ensure that the industry offers basic services at acceptable levels of service quality.[20]

Furthermore, although the industry seeks to portray cost accounting as an albatross, rational suppliers in competitive markets rely on cost data to support strategic development and pricing. Those products for which key variables (such as consumer demand and revenues) are favorable relative to the associated costs will be pursued more actively.[21] Even a monopolist seeks information about average and marginal costs in

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[18] / Board of Public Utilities, Regulations of Cable Television Proposed Readoption with Amendments and New Rules: N.J.A.C. 14:18, at 3. In comments submitted to the FCC, Verizon similarly stated: "[i]n a market where all services – interstate, intrastate, wireline, wireless, local, long distance, basic, and enhanced – are competitively disciplined, regulatory cost allocation requirements such as the separations rules are not only unnecessary to protect ratepayers, but destructive of true competition." *In the Matter of Petition of BellSouth Telecommunications, Inc. For Forbearance Under 47 U.S.C. § 160 from Enforcement of Certain of the Commission's Cost Assignment Rules*, FCC WC Docket No. 05-342, Comments of Verizon, January 23, 2006, at 6-7.

[19] / In a similar vein, Qwest Communications stated last year, "[d]etailed separations/cost allocation rules and competition are basically incompatible -- because cost allocation has little or no affect (sic) on prices in a competitive environment." FCC CC Docket No. 80-286, Qwest *ex parte*, April 27, 2006, at 6.

[20] / Indeed, as the discussion of duopolies in Section 2.5 explains, competition does not exist in many of the unregulated telecommunications markets.

[21] / Of course, if a supplier in a competitive market decides affirmatively to cross-subsidize its products (for example, by setting a low price for a digital camera and a high price for printing digital photos), there are no adverse implications for consumers, competitors, and the industry structure. By contrast, in telecommunications markets, ILECs' supply of competitive and noncompetitive products creates specific concerns, for which regulators require cost accounting data.

order to maximize profits. As one economics textbook states, "a profit-maximizing monopolist produces that quantity for which marginal revenue is equal to marginal cost."[22] Competitive companies seek to focus on financially lucrative products and to discontinue pursuit of the less profitable ones, and in order to achieve that focus, require relevant cost data.

2.3. Price cap regulation does not provide adequate consumer protection as telecommunications and cable companies enter each others' traditional lines of business.

A frequent Bell argument is that price cap or alternative regulation obviates the need for regulation (in the form of requiring accounting separations; structural separations; or even access to cost data). *Theoretically*, the purpose of price cap regulation is to yield rates that would exist in an effectively competitive market. However, *in reality*, price cap systems differ (with varying productivity factors, basket designations, rules for price changes, etc.), which is evidence of the fact that there is no "perfect" price cap system. Furthermore, intrastate and interstate rates in New Jersey are long overdue for re-initialization as a result of Verizon's increasing use of common and joint resources to enter new lines of business. Until such a re-initialization occurs, the FCC's and the Board's alternative forms of regulation cannot yield just and reasonable rates. Additionally, the FCC is considering the issue of the alleged supracompetitive special access prices being charged by incumbent local exchange carriers ("ILECs") in Docket WC 05-25, and as such, faith in the interstate price cap system would be seriously misplaced.[23]

Moreover, any particular price cap system corresponds with the regulators' best efforts to design a mechanism that will create the proper incentives for investment and yield reasonable rates. Price cap and other forms of alternative regulation do not protect consumers and competitors from the subsidization of competitive offerings with revenues derived from regulated services. Establishing going-in rates and assessing the impact of exogenous events on price cap and alternative regulation plans requires an assessment of a carrier's revenue requirement: if ILECs assign and allocate excess amounts to the

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[22] / Walter Nicholoson, *Microeconomic Theory, Basic Principles and Extensions,* Seventh Edition, 1998, at 548. Also, "[a]lthough a monopoly may earn positive profits in the long run, the size of such profits will depend on the relationship between the monopolist's average costs and the demand for its product." *Id.*, at 550, cite omitted.

[23] / In 2005, the most recent year for which FCC ARMIS data is available, Verizon Communications' rate of return on its interstate special access services was 42%. Federal Communications Commission, ARMIS Report 43-04, Table I. Separations and Access Data. Rate of return is calculated by dividing Net Return (Row 8041) by Average Net Investment (Row 8040).

intrastate jurisdiction, then state rates will be too high.[24]

States that have de-regulated or relaxed the regulation of local rates may consider separations to be an arcane and irrelevant concern: since a price cap plan, for example, may govern rate changes, the underlying costs seemingly are no longer an issue of concern. However, many current prices (often set under price caps) are not just and reasonable. Another limitation of price cap plans is that ILECs have an economic incentive to bring exogenous events that *raise* their costs to the attention of regulators but lack a corresponding incentive to alert regulators to exogenous events that *lower* their regulated costs. If price cap regulation worked efficiently, major exogenous events such as jurisdictional and regulatory shifts in the treatment of voice over Internet protocol ("VoIP"), ISP-bound traffic, and DSL should lead to a decline in rates under price caps.

Bell companies (such as Verizon in New Jersey) are entering video markets, yet are not providing regulators with data about how they account for these new costs. As Chapter 4 explains, the Board and the FCC have a statutory obligation to ensure that ILECs allocate the local loop fairly between regulated and unregulated services. A cap on rates (thus ensuring no increases, but also not ensuring decreases if the cost to provide basic local exchange service declines) is not sufficient evidence that rates are just and reasonable. The existing jurisdictional split of costs is based on a legacy network. If Verizon allocated a fair share of the common network to the interstate jurisdiction, based on regulatory decisions such as the treatment of DSL and broadband services, state costs would decline and state rate caps should similarly decline.

2.4. Neither the telecommunications nor cable companies' traditional markets are competitive and the incumbent carriers still dominate their respective markets.

2.4.1. Incumbent telecommunications companies and cable operators dominate their traditional turf.

Consumers who seek basic local exchange service (without any bundled offerings) continue to rely on Verizon's ubiquitous public switched network. In the

[24] / A Court decision in 2005 provides further evidence of the need for cost studies, even when carriers are governed by alternative forms of regulation ("AFOR"). In 2005, the Maine Supreme Judicial Court remanded a Public Utilities Commission decision adopting a new AFOR because the "Commission failed to undertake even a cursory comparison of the local rates that would be set under an ordinary ROR proceeding" to the rates that would result from the AFOR plan as required by the legislature. *Office of Public Advocate, et al. v. Pub. Utils Comm'n.*, 866 A 2.d 851 (2005), at para. 9. The Court decision also addressed the Maine PUC's incorporation of a local rate increase to offset decreases in Verizon's access charges. *Id.*, at para. 39-43, fn 8. Verizon's assignment and allocation of costs are among the issues presently under investigation by the Maine Public Utilities Commission as a result of the Court's remand. *Investigation into New Alternative Form of Regulation for Verizon Maine Pursuant to 35-A M.R.S.A. § 9102-9103*, Maine Pubic Utilities Commission, Docket No. 2005-155.

absence of mass market competition, consumers have little choice of suppliers of basic telephone service. Similarly, consumers who seek basic cable service (without any bundled offerings) continue to rely on cable company services, with little choice of suppliers of basic service. The competition that is emerging between the telco and cable industries is *not* for the consumer of either basic telephone or basic cable service, but rather for the consumer of bundled packages.

2.4.2. Evidence demonstrates that the incumbent cable operators still dominate the cable market.

Rising cable rates indicate that the cable market is not yet effectively competitive. In a report released in December 2006 detailing cable industry prices, the FCC concluded that cable prices have risen more than 5% in the past year, and over 93% since the period immediately preceding implementation of the 1996 Act.[25] Prices for expanded basic cable rose more than 6%, which is approximately twice the rate of inflation.[26] The report concludes that these price increases are indicative of inadequate competition in the cable industry.

In a statement accompanying the report, FCC Chairman Kevin J. Martin concluded that more competition is necessary in the cable market. "Cable does face some competition from DBS [satellite TV service], but our report reveals that DBS and cable do not seem to compete on price. In other words, the presence of a DBS operator does not have an impact on the price the cable operator charges its subscribers."[27] Commissioner Copps noted that the report "discloses that there is a positive relationship between local market share and cable prices, as well as between a provider's number of nationwide subscribers and prices. In other words, customers of a large national cable company that controls a large share of a local market generally pay more than customers of a company with either a smaller national or local market share."[28] Commissioner Jonathan S. Adelstein suggests that "Few other goods and services in America cost nearly twice today what they did in 1995."[29]

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25 / *In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992 and Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment*, FCC MM Docket No. 92-266, *Report on Cable Industry Practices*, Rel. December 27, 2006, at 1.

26 / *Id.*

27 / Statement of Chairman Kevin J. Martin, Re: *Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992 and Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment*, FCC MM Docket No. 92-266.

28 / Concurring Statement of Commissioner Michael J. Copps, Re; *Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992 and Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment*, FCC MM Docket No. 92-266.

29 / Concurring Statement of Commissioner Jonathan S. Adelstein, Re; *Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992 and Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment*, FCC MM Docket No. 92-266.

In contrast with these findings, the New Jersey Cable Telecommunications Association ("NJCTA") makes the following statement on its website:

> Is cable a monopoly? In a word – No . . . NJCTA members operate in a competitive environment and face all of the risks and rewards inherent in a free market system . . . To begin, cable franchise agreements are not exclusive - municipalities are free to (and, indeed, sometimes do) allow more than one cable operator to provide service to their residents. Any cable company can apply to compete against an existing cable operator and franchise agreements regularly come up for review and competitive bid. Few may find it economically sound to do so, because of market conditions beyond anyone's control.[30]

Yet, a map of New Jersey cable systems provided on the NJCTA's website divides geographic areas among association members and fails to show overlapping areas, suggesting that certainly the incumbents have chosen not to compete in each others' home regions.[31]

Appendix 1 provides additional details with respect to the cable industry customer base, products and prices, and revenues – both nationwide and in New Jersey.

2.4.3. Verizon's dominance of the local exchange market in New Jersey enables it to cross-subsidize its entry into new markets.

As the following graphics and discussion demonstrate, Verizon NJ owns or controls 97% of the end-user switched access telephone lines in New Jersey.[32]

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30 / Statement of the New Jersey Cable Telecommunications Association at its website: http://www.cablenj.org/facts_cable_competition.asp.

31 / Available at http://www.cablenj.org/about_map.asp. The map is also included in Appendix 1.

32/ Federal Communications Commission, Wireline Competition Bureau, Industry Analysis and Technology Division, *Local Telephone Competition: Status as of December 31, 2005*, July 2006 ("FCC Local Competition Report"), at Tables 10 and 11. As noted previously, Embarq also provides service as an incumbent telecommunications carrier in New Jersey. However, its territory as an incumbent is relatively small in New Jersey and, as such, the focus in on Verizon's dominance of the local market. Embarq Corporation, formerly United Telephone Company (the Local Telecommunications Division of Sprint), served approximately 205,441 switched access lines in 2005 as an incumbent in New Jersey. By contrast, Verizon New Jersey served approximately 5,414,559 switched access lines in 2005. FCC ARMIS Report 43-08, Table II. Switched Access Lines in Service.

INCUMBENT CABLE AND TELECOMMUNICATIONS COMPANIES HAVE THE ABILITY TO ENGAGE IN IMPROPER CROSS-SUBSIDIZATION

Table 1
Incumbents Own or Control 97% of the New Jersey Local Exchange Lines as of December 31, 2005

Total incumbent lines	4,714,621
Total CLEC lines	1,282,352
Total end-user switched access lines	5,996,973
CLEC share of end-user switched access lines	21%
CLEC resold lines	606,709
CLEC UNE lines	498,785
CLEC-owned lines	176,858
Total CLEC lines	1,282,352
CLEC-owned lines as a percent of all lines	3%
Percent of all lines owned or controlled by incumbent	97%

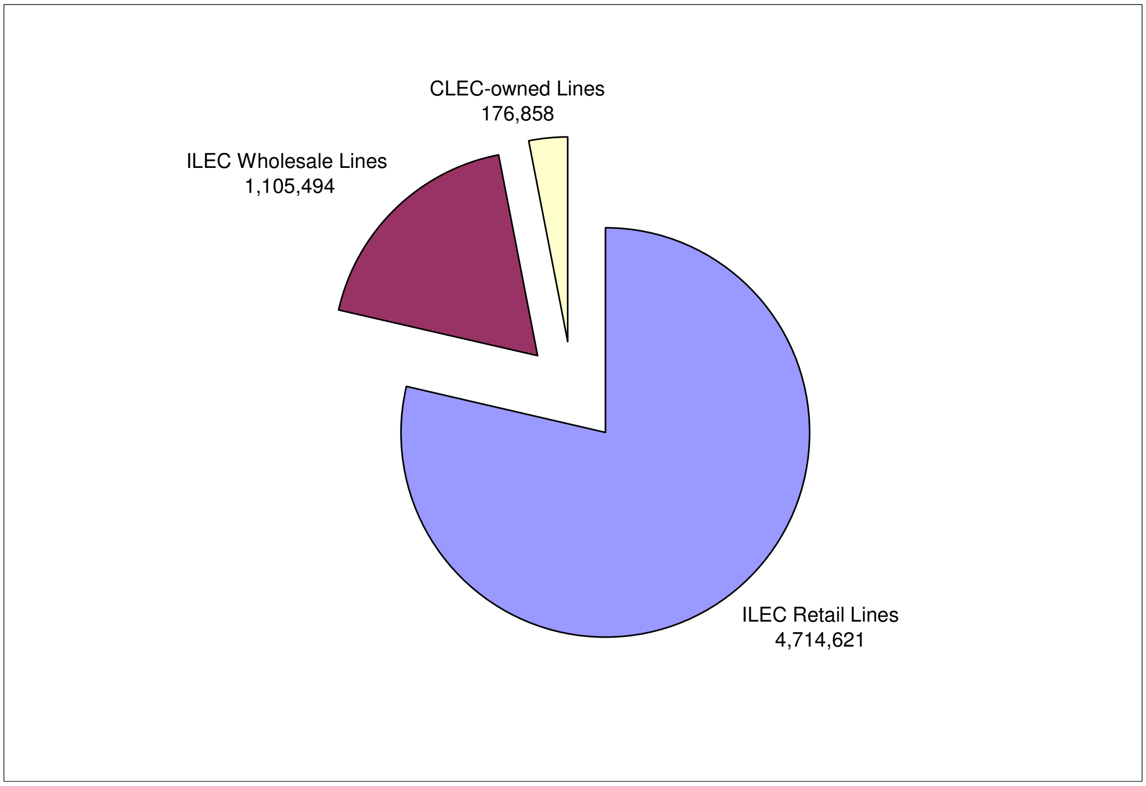
Source: FCC Local Competition Report, Tables 10 and 11.

Viewed solely on a retail basis, Verizon NJ has a 79% market share.[33] However, Verizon NJ dominates the local market either directly through its own retail services or indirectly by leasing wholesale facilities to its competitors (*i.e.*, the non-facilities-based competition that occurs through resale, unbundled network element platform ("UNE-P") and UNE loop). Most of the competitive local exchange carriers' ("CLECs") market share (*i.e.,* 86% of the CLECs' access lines) depends on incumbent facilities.

[33] / FCC Local Competition Report, at Table 11.

INCUMBENT CABLE AND TELECOMMUNICATIONS COMPANIES HAVE THE ABILITY TO ENGAGE IN IMPROPER CROSS-SUBSIDIZATION

Figure 1[34]
Incumbents Dominate the Local Market in New Jersey
(as of December 31, 2005)



Furthermore, competition from competitive providers using UNE-type arrangements is diminishing. Approximately 39% of the CLEC-provided end-user switched access lines in New Jersey as of December 31, 2005 were provided via UNEs.[35] Yet, the provision of CLEC lines through UNE or UNE-type arrangements is dropping off in the wake of the FCC's *Triennial Review Remand Order*.[36] UNE-P (UNEs with switching) peaked at 17.1 million nationwide in June 2004 and has declined 37% since that time to 10.8 million nationwide in December 2005.[37] In New Jersey, the number of

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[34] / *Id.*

[35] / *Id.* This data overstates CLECs' presence because it includes any lines that MCI was providing in December 2005 as part of the CLEC data. MCI and Verizon merged in January 2006. *Id*., at 2, footnote 5.

[36] / *Unbundled Access to Network Elements; Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, FCC WC Docket No. 04-313; CC Docket No. 01-338, *Order on Remand*, Rel. February 4, 2005 ("Triennial Review Remand Order" or "TRRO").

[37] / FCC Local Competition Report, at Table 4.

lines served with UNEs fell almost 51% from June 30, 2005 to December 31, 2005.[38] The dramatic decline in UNE-P lines contrasts sharply with UNE-P's former importance as an entry mode for competitive suppliers.

Furthermore, the position of CLECs negotiating access to UNE-P facilities is now seriously weakened due to the expiration of regulated UNE-P access in March 2006.[39] The declining prospect for robust wireline competition is best evidenced by the decision of MCI and legacy AT&T (two of the largest CLECs) to throw in the towel and merge with RBOCs. In its 2004 Annual Report, MCI made the following representation to its investors:

> As a participant in the competitive local telecommunications industry in the United States, we rely on the networks of established telephone companies or those of competitive local exchange carrier for some aspect of transmission. Federal law requires most of the established telephone companies to lease or "unbundle" elements of their networks and permit us to purchase the call origination and call termination services we need, thereby decreasing our operating expenses. However, as a result of recent litigation concerning portions of the FCC's Triennial Review Order that required the unbundling of switching, which is a critical component of UNE-P, the FCC has determined that beginning in 2006, certain discounts provided to us by the established telephone companies will cease. We are continuing to evaluate how the anticipated rise in UNE-P access costs will impact our ability to profitably provide Mass Markets subscription services, and the cost increase may force us to withdraw from certain markets. As a result, new local account installations and revenue may decrease from current levels in future periods. These regulatory changes will also increase costs for our other business segments as well and could adversely affect our competitive position in these segments.[40]

During the FCC's review of the Verizon/MCI merger, the two companies repeatedly suggested that MCI's business was declining and that MCI was not a competitor for

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[38] / *Id.*, at Table 11; Industry Analysis and Technology Division, Wireline Competition Bureau, *Local Telephone Competition: Status as of June 30, 2005*, April 2006, at Table 11. The number of lines served by CLEC through UNEs fell from 1,014,796 in June of 2005 to 498,785 in December 2005. *Id.*

[39] / Furthermore, the FCC's conditions on the Verizon/MCI merger are weaker than those that have apparently been approved for the AT&T/BellSouth merger, providing less protection for New Jersey customers than for those in AT&T's 22-state region. Letter from Robert W. Quinn, Jr., Senior Vice President Federal Regulatory, AT&T to Ms. Marlene H. Dortch, Secretary, Federal Communications Commission, Re: Notice of Ex Parte Communications In the Matter of Review of AT&T Inc. and BellSouth Corp. Application For Consent to Transfer of Control, WC Docket No. 06-74, December 28, 2006 ("AT&T/BellSouth Merger Conditions"); *In the Matter of Verizon Communications Inc. and MCI, Inc. Applications for Approval of Transfer of Control*, FCC WC Docket No. 05-75, *Memorandum Opinion and Order*, Rel. November 17, 2005 ("FCC Verizon/MCI Merger Order"), at Appendix G: Conditions.

[40] / MCI, Inc. Form 10-K, Annual Report for the fiscal year ended December 31, 2004, at 17.

Verizon's mass-market voice services.[41] Yet, AT&T and MCI were the largest CLECs competing with Verizon for mass market customers, casting doubt on the prospects for other wireline competitors.

Finally, the FCC estimates that 50% of the lines served by CLECs over their own loop facilities are provided over coaxial cable connections and 36% of CLEC residential lines are served by coaxial cable connections.[42] Thus, what little competition does exist relies on a cable-telco duopoly, which Section 2.5 below discusses.

2.4.4. Verizon's dominance extends to adjacent telecommunications markets.

Verizon is also quickly re-monopolizing the long distance market. One of the key regulatory freedoms that the Bell companies obtained in recent years is "Section 271" approval, which granted long distance authority. Furthermore, legacy SBC's acquisition of legacy AT&T, and Verizon's acquisition of MCI eliminated major rivals to all of the Bell companies, including Verizon NJ, further entrenching their control of the long distance market. Verizon offers diverse "Freedom" packages of local, long distance, data, and video services which, in turn, raises concerns regarding anti-competitive cross-subsidization.[43] Across Verizon's operating territory:

- Verizon reported a 50% increase in mass-market bundle subscriptions between June 30, 2005 and June 30, 2006 and, as of September 30, 2006, provided 7.5 million mass market customers with its Freedom packages;[44]

- The total number of long distance lines served by Verizon increased 15.5% between year-end 2003 and year-end 2004, and increased 5.7% between year-end 2004 and year-end 2005.[45]

The Bell companies have been far more successful in entering new markets than have CLECs. The 1996 Act was enacted more than a decade ago, and yet CLECs

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41 / *Verizon Communications, Inc. and MCI, Inc. Applications for Approval of Transfer of Control*, FCC WC Docket No. 05-75, Application for Transfer of Control, March 11, 2005, Appendix 1: Public Interest Statement, at 49 and Declaration of Robert W. Crandall and Hal J. Singer, at para. 33.

42/ FCC Local Competition Report, at 2.

43 / See Appendix 2, which includes illustrative copies of Verizon's web pages.

44 / Verizon Communications, *Investor Quarterly: Third Quarter 2006*, October 30, 2006, at 6. The number of subscribers to Verizon Freedom packages (which include local wireline services with a combination of long distance and/or Internet access service) rose from approximately 5 million in the third quarter of 2005 to 7.5 million in the third quarter of 2006.

45 / Verizon Communications, 2005 Annual Report, at 16. As of the end of the first quarter 2005, 58% of Verizon residential customers subscribed to local and long distance and/or DSL service. Verizon Communications, *Investor Quarterly: First Quarter 2005*, April 27, 2005, at 3.

collectively have garnered, at most, a 19% percent share in the local market.[46] In approximately half the time, Verizon has made twice the inroads into the long distance market than all the CLECs have made over ten years. In other words, collectively the CLECs have been less than half as successful as the Bells have been, and have taken about twice as long as the Bells to achieve that tenuous success.

Verizon's substantial and unique advantage in the race to offer bundled packages is directly tied to its century-long relationship with consumers, as the primary link to the public switched telephone network. Mass market consumers, through many years of predictable demand for Verizon's essential local telephone services, provided a largely risk-free source of revenue, which enabled Verizon to establish a formidable position in the telecommunications marketplace. Also, Verizon's access to this vast customer base gives it an enviable edge in marketing new products.

As Verizon moves into new lines of business, including broadband and video markets, it is essential to ensure that basic noncompetitive services are not subsidizing these new services and that low-volume, demand-inelastic customers are not subsidizing high volume customers. It is also essential to ensure that Verizon does not neglect the more "mundane" responsibilities of installing and repairing basic telephone service in a timely manner.[47] Verizon's dominance of adjacent markets throughout New Jersey provides it with a significant opportunity to cross-subsidize its entry into new lines of business, such as its video service. Furthermore, the lack of competition means that regulators cannot rely on market forces to ensure proper cost allocation.

2.4.5. Intermodal competitors do not constrain dominant carriers' market power.

Contrary to industry hype, intermodal services (*i.e.,* non-wireline services) do not adequately constrain Verizon's market power. Wireless, facilities-based VoIP, and "over-the-top" VoIP services do not constrain Verizon NJ's prices and service quality for basic voice grade service. The product supplied by "over the top" providers, such as Vonage, for example, requires that subscribers provide their own broadband Internet access (*i.e.,* rely on the cable-telco duopoly). In its *Verizon/MCI Merger Order*, the FCC excluded over-the-top VoIP services from the relevant product market.[48] In so doing, the Commission noted that the various over-the-top services:

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[46]/ According to FCC-reported data, as of December 31, 2005, CLECs account for 18% of end-user switched access lines, down from 19.1% in June 2005. FCC Local Competition Report, at Table 1.

[47]/ In Verizon Communications' second quarter 2006 Investor Quarterly, Ivan Seidenberg, Verizon's chairman and CEO states: "Verizon Telecom is tightly controlling costs in traditional businesses as we make the fiber network investments to accelerate growth and market expansion." Verizon Communications, *Investor Quarterly: VZ Second Quarter 2006,* August 1, 2006, at 2. *See* Sections 3.9.1 through 3.9.3 for analysis of Verizon NJ's service quality.

[48]/ *FCC Verizon/MCI Merger Order*, at para. 89.

> . . . differ significantly in their service characteristics, including quality of services and price. The extent to which consumers view these services as substitutes for traditional wireline local service may vary based on these differences. In addition, the requirement that a customer have broadband access to be able to use certain over-the-top VoIP services affects the substitutability of those services with wireline local services.[49]

The FCC noted that such a requirement for broadband access made substitution "uneconomical" and further concluded that even those consumers who already subscribed to broadband services may still not be willing to view over-the-top services as substitutes depending on "the attributes of the service and the consumer's willingness to trade off service characteristics for lower prices."[50] A study conducted last year by Brix Networks corroborates the FCC's analysis that VoIP services may not have the same level of quality and concludes that, based on approximately one million VoIP connections tested through its Web site, 20 percent had unacceptable quality, which was an increase from 15 percent the year before.[51] Furthermore, VoIP's price advantage may also be diminished in the future. The FCC recently issued an order wherein, among other things, it requires VoIP providers to contribute to universal service.[52] The impact of this new requirement on VoIP prices and demand is uncertain.

Finally, the Board has similarly made a finding that intermodal services do not constrain Verizon NJ's market power. The Board undertook its own analysis of the state of competition in New Jersey as part of its investigation of the proposed Verizon/MCI merger. In its Order approving the merger,[53] the Board found that intermodal technologies do not currently serve as an economic substitute for wireline services in New Jersey's local market for either enterprise or mass market customers.[54] The Board acknowledged Verizon's and MCI's position that price constraining competition takes place at the margins, and thus intermodal competition need not reach all consumers, but the Board faulted the Petitioners for failing to "actually opine as to how large a percentage of 'early adopters' is required for pricing discipline to occur."[55] In reviewing the evidence, the Board made the following conclusions with respect to the mass market:

49/ *Id.* (citation omitted).

50/ *Id*.

51/ "Study: Net telephony quality worsening," Marguerite Reardon, C/Net News.com, July 25, 2006, http://news.com/2102-7352_3-6097912.html?tag=st.util.print. *See*, also, "Clear as a Bell One Day, Fuzzy and Garbled the Next," Ken Belson, *New York Times*, September 27, 2006.

52/ *In the Matter of Universal Service Contribution Methodology*, FCC WC Docket No. 06-122, *Report and Order and Notice of Proposed Rulemaking*, Rel. June 27, 2006, paras. 16, 34-62.

53/ *In the Matter of the Joint Petition of Verizon Communications Inc. and MCI, Inc. for Approval of Merger*, New Jersey Board of Public Utilities Docket No. TM05030189, *Order of Approval*, April 12, 2006 ("NJ BPU Verizon/MCI Merger Order").

54/ *Id.*, at 33-35, 36.

55/ *Id.*, at 36.

> In the case of the aforementioned technologies except wireless, market penetration rates are very low. Thus, we are not willing to accept on this record that intermodal technologies such as VoIP, WiFi, WiMAX and cable telephony currently constrain Verizon's wireline pricing to a meaningful degree.[56]

The Board also found the rate at which consumers were "cutting the cord" was insufficient to constrain Verizon's wireline pricing. The Board agreed with the Rate Counsel in finding that "wireless service is currently viewed by the majority of its users as a supplement to wireline service rather than a substitute."[57]

Moreover, the Board found that none of the intermodal technologies, which Verizon and MCI characterized as substitutes for enterprise wireline services, sufficiently disciplined Verizon NJ's behavior in the small business market. The Board concluded that the various technologies identified by Verizon and MCI are either not true economic substitutes (*e.g.,* wireless and VoIP) or have not been adopted by enough subscribers to provide price constraining competition (*e.g.,* cable, WiFi).[58] The Board stated:

> . . . acknowledging the increasing presence of such technologies is not the same as concluding that they sufficiently mitigate competitive harms created by the merger by constraining ILEC wireline pricing. In fact, we conclude that in New Jersey such alternative technologies have not yet had this effect in the business market.[59]

Furthermore, Verizon has a stake in some of these "competitive" intermodal alternatives, such as wireless services. For example, the fact that Verizon offers bundles which include its own wireline and wireless services together in one package provides evidence that wireless is viewed, even by the carriers themselves, as a complement, rather than substitute, to wireline service. Verizon Communications reported to its investors in the third quarter of 2006 that Verizon Wireless is the largest US wireless company, based on revenues.[60]

The Bells' filings with the FCC and their statements to investors provide further evidence that the companies themselves view wireline and wireless services as complements. One of the reasons given by SBC and AT&T for their merger was the simplified governance of Cingular and the facilitation of "the merged firm's ability to

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[56]/ *Id.*

[57]/ *Id.*

[58]/ *Id.*, at 33-35.

[59]/ *Id.*, at 35.

[60]/ Verizon Communications, *Investor Quarterly: VZ Third Quarter 2006*, October 30, 2006, at 2.

jointly market wireline and wireless services to mass market and business customers."[61] In 2005, Verizon Communications stated in a quarterly report to investors: "Verizon Freedom plans help retain and win back customers by offering local services with various combinations of long-distance, wireless and Internet access, available on one bill."[62] In August 2006, Verizon Communications reported to investors that Verizon Freedom packages "have been instrumental in retaining retail wireline customers."[63] Verizon Communications announced in October 2006 a new service offered to Texas consumers, "Verizon Complete Freedom" that includes both "traditional" and wireless phones and airtime-free calling between Verizon wireless and home phones. The service provides one bill and one integrated voice mail service.[64] On a recent earnings conference call Verizon's Chief Financial Officer and Executive Vice President, Doreen Toben, stated:

> We tend to view additional or secondary line losses being driven more by secular change and technology substitutions than competition. In fact, our own broadband initiatives are influencing customers to disconnect their additional lines. Our bundling and broadband initiatives are starting to take hold. We believe that this expanded customer relationship will improve revenue per household and increase customer loyalty, thereby improving retention.[65]

2.5. The cable-telco duopoly does not provide effective competition.

In September 2005, the FCC adopted its *Wireline Broadband Order*, which determined that wireline broadband Internet access services were "information" services, and which sought to adopt a "consistent regulatory framework across platforms by

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61/ *In the Matter of BellSouth Corporation and AT&T Inc. Application Pursuant to Section 214 of the Communications Act of 1934 and Section 63.04 of the Commission's Rules for Consent to the Transfer of Control of Bellsouth Corporation to AT&T Inc*, WC Docket No. 06-74, Application for Consent of Transfer of Control, filed March 31, 2006, Declaration of Dennis W. Carlton and Hal S. Sider, at para. 10 (emphasis added). *See*, *also*, *Id.*, at para. 52, stating "The proposed transaction eliminates impediments to developing innovating marketing strategies involving wireless services. Such bundles enable customers to have a single point of contact for a broader range of services."

62/ Verizon Communications, Inc. Press Release, "Verizon Reports Continued Strong Results with EPS Growth of 8.6 Percent, Revenue Growth of 6.6 Percent," April 27, 2005, available at http://investor.vzmultimedia.com/news/view.aspx?NewsID=621.

63 / Verizon Communications, *Investor Quarterly: VZ Second Quarter 2006,* August 1, 2006, at 6.

64 / Verizon Communications, *Investor Quarterly: VZ Third Quarter 2006*, October 30, 2006, at 16.

65 / VZ – Q3 2006 Verizon Earnings Conference Call, October 30, 2006, Thompson Financial, Final Transcript available at http://investor.verizon.com/news/20061030/3q06_vz-transcript.pdf, at 4.

regulating like services in a similar functional manner . . ."[66] (*i.e,*. treating cable modem and DSL services in the same manner).[67] The FCC opted to adopt a "lighter regulatory touch" in order to "promote the availability of competitive broadband Internet access services to consumers, via multiple platforms, while ensuring adequate incentives are in place to encourage the deployment and innovation of broadband platforms consistent with our obligations and mandates under the Act."[68] The FCC described the broadband Internet access market in the following manner:

> We fully recognize that not all American households can choose between cable modem and DSL-based Internet access service today. But a wide variety of competitive and potentially competitive providers and offerings are emerging in this marketplace. Cable modem and DSL providers are currently the market leaders for broadband Internet access service and have established rapidly expanding platforms. There are, however, other existing and developing platforms, such as satellite and wireless, and even broadband over power line in certain locations, indicating that broadband Internet access services in the future will not be limited to cable modem and DSL service.[69]
>
> We expect providers of both platforms will continue to invest and extend the reach of their services. We anticipate that, as the availability of cable modem and DSL broadband Internet access services grows with the modernization of network infrastructure and increased service deployment, more households will have the option of choosing between the cable and DSL broadband options. Increased intermodal and intramodal competition will continue to encourage these two broadband providers to deploy broadband Internet access services throughout their respective service areas. In addition, the threat of competition from other forms of broadband Internet access, whether satellite, fixed or mobile wireless, or a yet-to-be-realized alternative, will further stimulate deployment of broadband infrastructure, including more advanced infrastructure such as fiber to the home.[70]

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[66]/ *Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, Universal Service Obligations of Broadband Providers*, CC Docket No. 02-33, et al., *Report and Order and Notice of Proposed Rulemaking*, 20 FCC Rcd 14853 (2005) ("Wireline Broadband Order"), at para. 1. *See*, *also*, para. 5.

[67] / Rate Counsel and the authors of this paper respectfully disagree with the FCC's determination that broadband Internet access services are information services, and consider them, instead, to represent transmission.

[68] / *Wireline Broadband Order*, at para. 3.

[69] / *Id.*, at para. 50 (notes omitted).

[70] / *Id.*, at para. 57.

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The FCC suggested that although the number of subscribers to cable modem and DSL services was very small, it expected that "[a]s the number of subscribers grows, so does the opportunity for alternative technologies and their respective providers."[71]

Yet, there is indisputable evidence that a cable-telco duopoly dominates the merging voice/data/video markets still today. Popular and trade press routinely discuss the cable-telco duopoly,[72] and recent consumer advocate and FCC Commissioner statements highlight the emerging duopoly.[73] In a dissenting statement accompanying the Commission's Order approving the division of Adelphia assets between Time Warner and Comcast, FCC Commissioner Copps stated:

> I am worried that this decision tightens the grip that cable companies share with telephone companies over our nation's broadband access. FCC data show that these two industries control some 98 percent of the broadband market. Despite this, the majority's Order goes on at length about the supposedly competitive broadband market. Indeed, the competitive picture the majority spins is at odds with too many other reports. A few weeks ago, the Congressional Research Service characterized the broadband market as a "cable and telephone duopoly."[74]

The Congressional Research Service report to which Commissioner Copps referred concluded: "With only limited alternatives to the cable and telephone broadband duopoly

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[71] / *Id.*, at para. 61.

[72] / *See*, *e.g.*, "A Wiring War Among Giants," Ken Belson, *The New York Times*, Section 14, at 1 and 10, December 10, 2006; Jason Lee Miller, "What An Un-Neutral Net Means to You," *Webpronews.com*, December 27, 2006; James S. Granelli, "Ma Bell is calling again, with a big voice," *latimes.com,* December 26, 2006; Brier Dudley, "Broadband rush is risky, Seattle," *seattletimes.com*, July 17, 2006; Peter Grant, "Cable Firms Woo Business in Fight for Telecom Turf," *The Wall Street Journal*, January 17, 2007, A1.

[73] / Mark Cooper, Director of Research for the Consumer Federation of America described the telco-cable duopoly in detail in testimony before the United States Senate Committee on Commerce, Science and Transportation in hearings regarding Competition and Convergence on March 30, 2006. His testimony is available at http://commerce.senate.gov/pdf/cooper-033006.pdf. Dr. Cooper noted that today, "there are only two local, last mile communications networks that can provide a fully functional broadband network to the residential consumer – the incumbent local telephone companies and the incumbent cable operators. Two is not a sufficient number to ensure vigorous competition, and both sets of incumbents have a miserable record of anticompetitive, anti-consumer behavior." *Id.*, at 4.

[74] / Dissenting Statement of Commissioner Michael J. Copps, Re: *Applications for Consent to the Assignment and/or Transfer of Control of Licenses; Adelphia Communications Corporation (and subsidiaries, debtors-in-possession), Assignors, to Time Warner Cable Inc. (subsidiaries), Assignees; Adelphia Communications Corporation (and subsidiaries, debtors-in-possession), Assignors and Transferors, to Comcast Corporation (subsidiaries), Assignees and Transferees; Comcast Corporation, Transferor, to Time Warner, Inc., Transferee; Time Warner In., Transferor to Comcast Corporation, Transferee, Memorandum Opinion and Order*, FCC MB Docket No. 05-192, July 13, 2006; *See,* also, Statement of Commissioner Michael J. Copps, Re: *Amendment of Part 15 Regarding New Requirements and Measurement Guidelines for Access Broadband over Power Line; Carrier Current Systems Including Broadband over Power Line Systems, Memorandum Opinion and Order*, August 3, 2006.

for the foreseeable future, and with the cable and telephone companies both pursuing largely the same business plan, the broadband providers might have both the incentive and the ability to exploit their control over access to end users to restrict competition (and the innovation it might bring) and harm consumers."[75] FCC Commissioner Copps cited the report again in August of 2006 in his statement regarding the Commission's Order defining the regulation of Broadband over Power Line services, stating:

> We all have high hopes for Broadband over Power Line and I think we would all like to see some non-duopoly pipes bringing broadband access to, particularly, hard-to-reach Americans. We are behind the game in putting high-speed, high value bandwidth to work for all our citizens. You know something is wrong when the best case scenario is that a consumer has a choice between two broadband connections, both of which are more expensive and considerably slower than what consumers in other industrialized nations enjoy. And that's how it works in our wealthy metropolitan areas. Over much of the rest of America, it just gets worse . . . The reason we're so far behind, of course, is that – in the words of the Congressional Research Service – our residential broadband market is a flat out "cable and telephone duopoly." Indeed, this market has an HHI index of roughly 5,500 to 5,800 – well over three times what the Department of Justice considers "highly concentrated." And this is not just some run of the mill product like a toaster or a lawnmower – it is the data pipe over which all future communications will run.[76]

FCC Commissioner Adelstein, in his statement regarding the FCC's approval of the merger between AT&T Inc. and BellSouth Corporation, also has taken note of the cable-telco duopoly, referring to "a market in which telephone and cable operators control nearly 98 percent of the market."[77]

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[75] / Charles B. Goldfarb, *Access to Broadband Networks*, Congressional Research Service, CRS Report for Congress, Order Code RL33496, June 29, 2006, at 17.

[76] / Statement of Commissioner Michael J. Copps, Re: *Amendment of Part 15 Regarding New Requirements and Measurement Guidelines for Access Broadband over Power Line; Carrier Current Systems Including Broadband over Power Line Systems, Memorandum Opinion and Order*, August 3, 2006. The Hirfindahl Hirschman Index ("HHI") is a well-known measure of market concentration. U.S. Department of Justice and the Federal Trade Commission, *Horizontal Merger Guidelines*, issued April 2, 1992, revised April 8, 1997 ("Horizontal Merger Guidelines"), § 1.5; F.M. Scherer, *Industrial Market Structure and Economic Performance*, Rand McNally & Company, Chicago, 1970, 50-52. The HHI is computed as the sum of the squares of each firm's market share. If a single firm serves a market, the HHI is 10,000 (the highest possible HHI), and if two firms each equally serve a market the HHI of that market is 5000. The larger the HHI, the greater the concentration. Markets with HHI below 1000 are considered to be unconcentrated; those with an HHI between 1000 and 1800 to be moderately concentrated, and those with an HHI above 1800 to be highly concentrated. *Horizontal Merger Guidelines,* § 1.51.

[77] / Statement of Commissioner Jonathan S. Adelstein, Concurring, Re: *AT&T Inc. and BellSouth Corporation Application for Transfer of Control, WC Docket No. 06-74, Memorandum Opinion and Order*, December 29, 2006.

INCUMBENT CABLE AND TELECOMMUNICATIONS COMPANIES HAVE THE ABILITY TO ENGAGE IN IMPROPER CROSS-SUBSIDIZATION

The Chairman of the House Subcommittee on Telecommunications and the Internet, U.S. House of Representatives, referred to the broadband, or digital, duopoly at a conference in January 2007:

> The second piece of bad news is that broadband service to residential consumers in the United States is dominated by a "digital duopoly" of two technologies – cable modem and telephone company DSL service. If one looks at the FCC data, what one finds is that even simply counting services that provide just 200 kilobits per second in ONE direction, alternative technologies such as wireless services or broadband-over-powerlines make up just over 1% of the market. When you count those services to residential consumers offering 200 kilobits per second in TWO directions, the FCC data shows that the share of wireless and powerline-based technologies is under 1% of the residential market. So, again, the cable industry's cable modem and the telephone companies' DSL technologies are going to be a digital duopoly into residential homes for the foreseeable future. This has implications for affordability, for innovation, and for the need for sensible rules for network neutrality to safeguard the Internet.[78]

Chapter 5 further discusses the fact that the widespread support for net neutrality is based largely on concerns of duopoly-controlled information pipes.

2.5.1. Evidence of a duopoly market structure.

FCC data corroborates press, regulator, and consumer advocate descriptions of the market as a duopoly. As of year-end 2005, cable modem and ADSL technology represented 57.5% and 40.5%, respectively of residential high-speed lines.[79] Thus, the cable and telephone companies control at least 98% of the broadband pipes to homes in the United States.[80] Figure 2 shows the growth in residential cable modem and DSL lines from year-end 1999 to year-end 2005, nationwide.

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[78] / Congressman Ed Markey (7th District Massachusetts) Statement at the Voice On the Net (VON) Conference, January 18, 2007, Boston, Massachusetts, available at http://markey.house.gov/index.php?option=com_content&task=view&id=2116&Itemid=46. Congressman Ed Markey is the current Chairman of the House Subcommittee on Telecommunications and the Internet, U.S. House of Representatives.

[79] / FCC High-Speed Services July 2006 Report, at Chart 6. The FCC defines high-speed lines as services to end-user locations delivering speeds that exceed 200 kbps in at least one direction. Advanced services (a subset of high-speed lines) provide services with speeds exceeding 200 kbps in both directions. *Id.*, at Notes for Tables 1-5 and Charts 1-9, Note 1. Additionally, optical fiber to the subscriber's premises (*e.g.* Fiber-to-the-Home) – presumably served by the telecom companies – represents 0.5% of the market and SDSL and other wireline technologies represent 0.3% of the residential high-speed line market. *Id.*

[80] / As noted above the telephone companies also provide fiber and wireline technologies for high-speed access. The FCC reports that *incumbent* local exchange carriers provided 96.3% of the reported ADSL lines and 55.3% of the traditional wireline connections. "When all technologies are considered, incumbent LECs reported 45.1% of total high-speed connections. *Id.*, at 2.

Figure 2[81]
Residential High-Speed Lines, 1999 to 2006

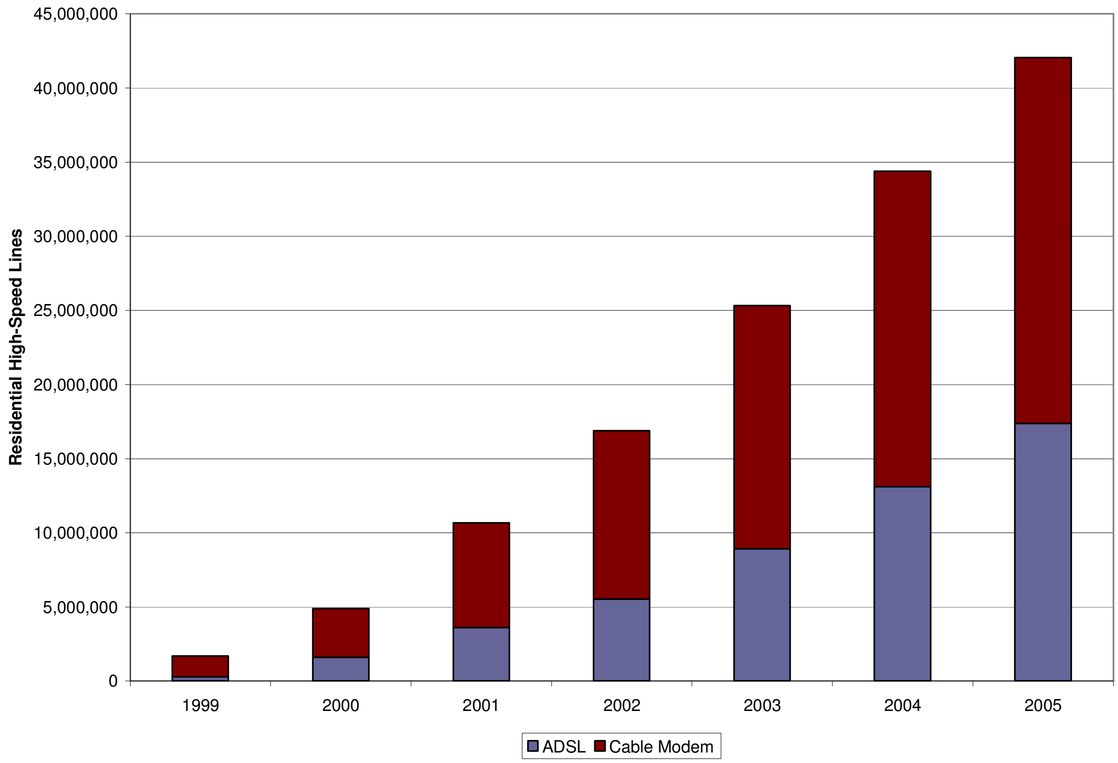


Figure 3, below, shows that in New Jersey there were 1,989,802 high-speed lines in service as of December 31, 2005, 540,382 (or 27%) were ADSL[82] and 1,205,182 (or 61%) were served by cable modem technology. Additionally, 7,967 lines were SDSL,[83] 13,556 were "other" traditional wireline services, and 8,317 were fiber lines (representing another 1.5% of the total high-speed lines in service).

As of year-end 2005, there were no broadband over powerline connections and the numbers for satellite, fixed wireless, and mobile wireless were "withheld to maintain firm confidentiality" indicating the very small percentage of lines these categories represent.[84] While there were more cable modem connections reported as of year end

[81] / *Id.*, at Table 3. The data in Figure 2 is year-end data (*i.e.* December 31, 2005 for 2005).

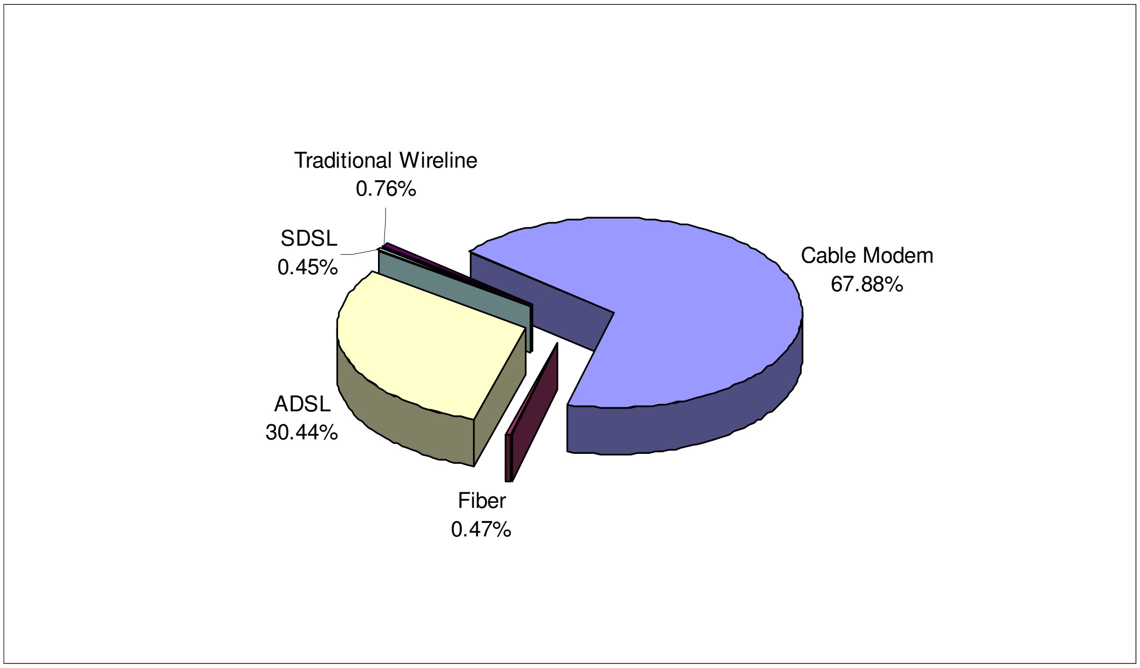
[82] / ADSL refers to asymmetric digital subscriber line technology, which provides speeds in one direction greater than speeds in the other direction (generally higher download than upload speeds). *See*, *e.g*., *Id.*, at Note 2.

[83] / SDSL refers to symmetric digital subscriber line, which provides the same download and upload speeds. *See*, *e.g*., *Id.*

[84] / *Id.*, at Table 9.

2005, the rate at which telephone companies added ADSL subscribers nationwide outpaced cable modem subscriptions additions in 2005.[85]

Figure 3[86]
The Cable-Telco Duopoly Dominates the Provision of High-Speed Lines in New Jersey



2.5.2. Defining a duopoly.

Duopoly, which is an extreme form of an oligopoly, is only one step away from a monopoly. In an oligopolistic market, a small number of firms compete in that market, and the firms' behavior, cost functions, and strategic interaction, as well as consumers' demand functions, affect the market structure.[87] One textbook describes the behavior of firms in an oligopoly as follows:

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[85] / *Id.*, at 2.

[86] / *Id.*, at Table 9.

[87] / Mas-Colell, Andreu, Michael D. Whinston and Jerry R. Green, *Microeconomic Theory* (New York: Oxford University Press, 1995), at 387 through 427; F. M. Scherer, *Industrial Market Structure and Economic Performance, Rand McNally & Company* (1970), at 131 through 157; Robert S. Pindyck and Daniel L. Rubinfeld, *Microeconomics*, 6th ed., Upper Saddle River, NJ: Pearson Prentice Hall, 2005, at 435-457. *See*, also, William G. Shepherd, *The Economics of Industrial Organization*, 3rd ed., Englewood Cliffs, NJ: Prentice-Hall, Inc., 1990. Shepherd states that oligopoly "is about fewness and interdependence. It ranges from pure duopoly, with just two firms, down to loose oligopolies with eight to ten substantial firms." *Id.*, at 72. The defining feature of an oligopolistic market is that the firms must consider the other firms' likely responses to their own actions in the market. *Id.*

> Any realistic theory of oligopoly must take as a point of departure the fact that when market concentration is high, the pricing decisions of sellers are interdependent, and the firms involved can scarcely avoid recognizing their mutual interdependence. If they are at all perceptive, the managers of oligopolistic firms will recognize too that profits will be higher when cooperative policies are pursued than when each firm looks only after its own narrow self-interest. As a result, we should expect oligopolistic industries to exhibit a tendency toward the maximization of collective profits, approximating the pricing behavior associated with pure monopoly.[88]

One of the defining features of the oligopoly (of which duopoly is one type) is that firms are engaged in strategic interactions with each other. Economist James Friedman notes that "[p]urely competitive markets lack this strategic interaction, because the choices of a single firm have no effect on the market price of the homogenous good the firms produce."[89] Certainly, a duopoly does not provide "effective competition." One Industrial Organization text states that effective competition requires "a reasonable degree of parity among the competitors" and enough competitors to prevent effective collusion and suggests that the largest market share of any competitor should be 15% or 20% of the market.[90] As the market becomes more concentrated, moving from oligopoly to duopoly, the likelihood of successful collusion becomes greater. One economist describes the spectrum in this manner: "The higher the concentration, the greater the likelihood that collusion will be successful . . . Accordingly, collusion is likely to crystallize and persist in tight oligopoly, whereas it is likely to fail in loose oligopoly. Tight oligopoly tends to become a 'shared monopoly,' as joint maximizing prevails over independent action."[91]

The FCC has contemplated the anticompetitive effects of market consolidation in recent proceedings. For example, in discussing its analytical framework for its review of the merger of Verizon Communications, Inc. and MCI, the FCC cited its earlier reasoning in the *EchoStar/DirectTV Order*:

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[88] / F. M. Scherer, *Industrial Market Structure and Economic Performance*, Rand McNally & Company (1970), at 157. Similarly, "An oligopoly is a market having few firms (but more than one firm) on the supply side and a very large number of buyers on the demand side, each of whom makes a negligible contribution to the market demand function. A buyer will take market conditions as given, for he cannot affect them, but a seller will inevitably be preoccupied with guessing the behavior to be expected from rival sellers . . . The key distinguishing feature that sets oligopoly apart from competition and from (textbook) monopoly is that oligopolists are strategically linked to one another. The best policy for one firm is dependent on the policies being followed by each rival firm in the market." James W. Friedman, *Oligopoly Theory*, Cambridge: Cambridge University Press, 1983, at 1.

[89] / James W. Friedman, *Oligopoly Theory*, New York: Cambridge University Press, 1983, at 2.

[90] / William G. Shepherd, *The Economics of Industrial Organization*, 3rd ed., Englewood Cliffs, NJ: Prentice-Hall, Inc., 1990, at 5, 16.

[91] / *Id.*, at 73.

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> Unilateral effects arise when the merging firm finds it profitable to alter its behavior following the merger. Examples of unilateral effects include a merging firm's raising its price or reducing the quantity it supplies. Coordinated effects, in contrast, arise when competing firms, recognizing their interdependence, take actions "that are profitable for each of them only as a result of the accommodating reactions of others." Because coordinated effects generally are more likely the smaller the number of firms in a market, mergers may significantly increase the likelihood of coordinated effects by reducing the number of firms. Examples include explicit collusion, tacit collusion, and price leadership.[92]

The FCC also noted in its *Verizon/MCI Merger Order*:

> It is generally recognized that the likelihood of coordinated effects depends on a number of factors, including the ease with which firms can reach tacit agreement, the incentive of firms to cheat, and the ability of the remaining firms to detect and punish such cheating.[93]

Collusion among firms in a duopoly need not be direct and can be "tacit," such as parallel pricing.[94] Indeed, at a recent analyst conference, AT&T Chairman and CEO Ed Whiteacre suggested that there would not be a "price war" between cable and telephone companies, stating "We're not going to chase that down." Instead, Whiteacre suggested that the companies would compete on the basis of who offers more services in their packages.[95] Such a view suggests that the companies will be competing to offer expensive bundles with lots of extras to the "high value" customers instead of reducing prices for basic services.[96]

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[92]/ *FCC Verizon/MCI Merger Order*, at fn 84, citing *EchoStar/DirecTV Order*, 17 FCC Rcd at 20609, para. 152.

[93]/ *Id.*, at para. 52, citing Jean Tirole, *The Theory of Industrial Organization* 239 (1988); George Stigler, "A Theory of Oligopoly," in *The Organization of Industry* 39 (1968); Alexis Jacquemin and Margaret E. Slade, "Cartels, Collusion, and Horizontal Merger," in *The Handbook of Industrial Organization* 415 (1989).

[94]/ William G. Shepherd, *The Economics of Industrial Organization*, 3rd ed., Englewood Cliffs, NJ: Prentice-Hall, Inc., 1990, at 74.

[95]/ Roger Chang, "AT&T CEO Backs View of Double-Digit Adjusted EPS Growth," *The Wall Street Journal Online*, May 31, 2006.

[96]/ *See*, *e.g.*, Mark Cooper, Director of Research for the Consumer Federation of America described the telco-cable duopoly in detail in testimony before the United States Senate Committee on Commerce, Science and Transportation in hearings regarding Competition and Convergence on March 30, 2006. His testimony is available at http://commerce.senate.gov/pdf/cooper-033006.pdf*; In the Matter of AT&T Inc. and BellSouth Corporation Applications for Approval of Transfer of Control*, FCC WC Docket No. 06-74, Comments of the New Jersey Division of the Ratepayer Advocate, June 5, 2006, at 5.

INCUMBENT CABLE AND TELECOMMUNICATIONS COMPANIES HAVE THE ABILITY TO ENGAGE IN IMPROPER CROSS-SUBSIDIZATION

While there are many positive benefits of convergence,[97] market consolidation and the marketing of "triple-play" and "quadruple play" bundles has tightened the hold of the telephone and cable companies on the market. One industry analyst characterizes the bundled services market as a duopoly. While duopoly is not, *de facto*, harmful to consumers, Paul R. Zimmerman describes the outcome in this manner:

> Of course, from a *policy* perspective, the ultimate question is whether two providers is sufficient to induce "competitive" outcomes in the local telecommunications market, i.e. retail prices that reflect the long-run incremental cost of provisioning the various services. And while it may very well be the case that the local exchange access market is most efficiently structured as a "natural duopoly" due to its demand and technological characteristics, regulators and policy makers cannot simply ignore the potential harms that economic theory often suggest will arise with fewer firms competing in a market. For instance, policy makers will need to address the possibility of a strategic "détente" between these two large facilities-based players (*e.g.*, the RBOC and cable company "splitting" the market by price matching each other's offerings, or simply competing "less aggressively" in other firm's traditional core line of business) while recognizing the potentially significant consumer benefits associated with product and service bundling/integration.[98]

In discussing both the ambition and ability of the RBOCs to squeeze intermodal competition out of the telecommunications market by strategically bundling services

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[97]/ Verizon and MCI described the implications of convergence in this manner in their application to the FCC seeking approval of their proposed merger:

> The transformation of the communications industry is a result of profound changes in technology. The deployment of digital, two-way, broadband capabilities, along with the growth of IP-based technologies, has finally brought about the long anticipated "convergence" among once-separate networks and providers. Wireline voice, data, cable, wireless, and satellite networks are now all capable of delivering an increasing array of innovative voice, data, and video services faster than ever before. Larger business and mass-market customers alike have enthusiastically adopted these new technologies and services, and increasingly use them both along with and in place of traditional offerings. These developments have shattered the artificial separation between local and long distance that has shaped industry regulation for the past two decades. The new providers rarely, if ever, offer the new services solely within these antiquated boundaries. And customers have not merely accepted these broader offerings, but have also embraced the newfound opportunity to purchase communications services on an integrated basis, from integrated providers.

Verizon Communications Inc. and MCI, Inc. Applications for Approval of Transfer of Control, FCC WC Docket No. 05-75, Application for Transfer of Control, March 11, 2005, Appendix 1: Public Interest Statement, at 2.

[98] / Paul R. Zimmerman, U.S. Federal Communications Commission, "Strategic Bundling in Telecommunications and its Antitrust Implications for Intermodal Competition," in *Antitrust Policy Issues*, Patrick Moriati, ed. New York: Nova Science Publishers, Inc., 2006, pp. 157-174, at 171-172.

(such as wireline with wireless services), Zimmerman suggests that cable companies may be the only source of intermodal competition for the RBOCs.[99] Zimmerman suggests that the competition between telephone companies and cable companies will be for bundled offerings, but suggests that regulators must "closely monitor the progression of competition between cable operators and the RBOCs, and implement the appropriate behavioral remedies in order to protect consumers when and if such competition is deemed to be insufficiently vigorous."[100] Zimmerman, like many economists, suggests that it is too early to tell whether the market presided over by "facilities-based regional duopolies" will lead to lower retail prices "or whether it will simply involve two carriers 'splitting' the (monopoly) level of profits between them."[101]

2.5.3. Duopolistic "competition" fails to protect consumers.

Although the FCC determined that wireline broadband is an information service,[102] the cable-telco duopoly does not provide sufficient competition to protect consumers from supracompetitive rates, service quality deterioration, and excessive control by telephone companies and cable companies of consumers' "information pipes." First, for consumers that seek basic plain old telephone service ("POTS") or basic cable as a single non-bundled service, a cable-telco duopoly, where both industries are competing to offer a bundle of voice, data, and video services to their customers, is

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[99] / This paper does not address the alleged intermodal competition in the telecommunications market in an exhaustive manner. However, BOC assertions regarding the abundance of intermodal competition have been rebutted in various proceedings. The New Jersey Board undertook an analysis of the state of competition in New Jersey as part of its investigation of the proposed Verizon/MCI merger. *See*, *NJ BPU Verizon/MCI Merger Order*. In its Order approving the merger, the Board found that intermodal services do not serve as an economic substitute for wireline services in New Jersey's local market for either enterprise or mass market customers. *Id.*, at 33-36. The BPU concluded: "we are not willing to accept on this record that intermodal technologies such as VoIP, WiFi, WiMAX and cable telephony currently constrain Verizon's wireline pricing to a meaningful degree." *Id.*, at 36. The Board further concluded that wireless services were viewed by consumers as supplements, instead of substitutes to Verizon's wireline service. *Id.*

[100] / Paul R. Zimmerman, U.S. Federal Communications Commission, "Strategic Bundling in Telecommunications and its Antitrust Implications for Intermodal Competition," in *Antitrust Policy Issues*, Patrick Moriati, ed. New York: Nova Science Publishers, Inc., 2006, pp. 157-174, at 173.

[101] / *Id.* *See*, also, William G. Shepherd, *The Economics of Industrial Organization*, 3rd ed., Englewood Cliffs, NJ: Prentice-Hall, Inc., 1990 and Hal R. Varian, *Intermediate Economics: A Modern Approach*, 5th ed., New York: WW Norton & Company, 1999.

[102] / *Wireline Broadband Order*, at paras. 5, 12.

irrelevant.[103] In the regulated monopoly model, regulators could ensure that all segments of society benefit from advanced technology.[104] Under today's deregulatory paradigm, where true competition has not yet arrived, but new services are unregulated, consumers are vulnerable to two distinct harms as the incumbent telephone companies roll out new technology: (1) some consumers will be left behind as the telco-cable duopoly races to attract and to lock in high-revenue customers; and (2) precisely those consumers who are left behind will be forced to subsidize new services.

Even those customers who are willing and able to pay for bundled packages of voice, data, and/or video services confront high transaction costs to migrate from one supplier to another. Transaction costs include the time and financial outlay for service installation, equipment, and an e-mail address change. Moreover, telecommunications service providers use various tactics to lock-in customers. Although some of these tactics may offer short-term consumer benefits, they also impose transaction costs if customers later wish to change service providers. Some of the tactics that deter migration include: offering discounts for one-year contracts, instead of month-to-month agreements; bundling necessary equipment with a long-term commitment; imposing early termination fees, and the non-portability of many features of the service.

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[103] / Verizon will surely seek to provide video services as part of a bundle of services to customers. The experience of cable companies entering the voice market illustrates this point well. The cable offerings are usually more expensive than a single, local wireline connection that low-income or elderly consumers may require. In order to qualify for a rate that is more comparable to a typical wireline rate, cable telephony customers typically must also subscribe to an entire bundle of services they may not need or desire. Even then, the phone service is more expensive than a basic, local line, in part because it usually includes unlimited long distance calling. For example, Cablevision's website indicates that a subscriber cannot buy Cablevision's Optimum Voice product without either subscribing to Cablevision's Optimum Online product or its "Triple Play" offering that includes iO digital cable, optimum online, and optimum voice products. With the "Triple Play" each service is $29.95 a month for the first year (http://www.optimum.com/order/triple_play.jsp accessed January 4, 2007). Comcast digital voice pricing, where available, is $39.95 for Voice in a package with Cable and Internet services; $49.95 for Voice in a package with Cable or Internet services; and $54.95 as a stand-alone product (pricing accessed for Jersey City address on January 4, 2007). Time Warner Cable has similar pricing, offering digital phone for $49.95 if a subscriber has no other services or even just analog cable service (http://www.timewarnercable.com/nynj/products/cable/packagesandpricing.html accessed January 17, 2006). In a recent survey of VoIP customers, eighty percent of cable VoIP customers indicated that they subscribed to VoIP and high-speed Internet access as a bundle. Brian Santo, "Survey: Cable VoIP subs more satisfied than pure-play VoIP customers," *CED*, May 25, 2006, available at http://www.cedmagazine.com/index.asp?layout=articlePrint&articleID=CA6338178.

[104] / *See*, *e.g.*, D.P.U. 89-300, where state regulators directed New England Telephone and Telegraph Company ("NET") (now Verizon) to accelerate its replacement of outdated electromechanical central office switches in rural Massachusetts so that some communities would not be left behind, lacking access to touch tone, while NET advertised then-new features, such as call waiting, in urban and suburban communities. Massachusetts D.P.U. 89-300, *New England Telephone Company*, June 29, 1990. In a separate order, the Massachusetts Department of Public Utilities (now the Department of Telecommunications and Energy) found that ISDN is a "monopoly, basic service that has a potentially far-reaching and significant role in the telecommunications infrastructure of the Commonwealth" and directed NET to deploy ISDN more broadly so that consumers could avail themselves of this then "advanced" technology. ISDN Basic Service, Mass. D.P.U. 91-63-B, February 7, 1992, p. 34.

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In addition to the business goal of seeking to attract customers in the high revenue segment of the market, the desire to lower customer churn is one of the industry's key motivating reasons for marketing bundled offerings to customers. The FCC recently stated in reviewing the Verizon/MCI merger:

> Verizon's documents reveal that its research and development, marketing, and corporate strategies focus upon service offerings designed to encourage consumers to subscribe to a local and long distance service bundle. Verizon's incentive is to drive consumers to purchase all telephone services from Verizon to reduce its marketing costs and churn, as well as to increase its average revenue per user.[105]

This lower customer churn ensures that customer acquisition is a higher priority than customer retention and thus "competition" in the market fails to ensure high quality service for existing customers.

Furthermore, it is not evident that the current level of competition between cable companies and telcos is providing market discipline. As noted above, cable prices continue to rise. Similarly, Verizon recently raised its DSL prices. A recent episode illustrates the continued need for regulatory oversight. The FCC determined in 2005 that DSL subscribers would no longer be required to pay into the federal universal service fund ("USF"), and also anticipated that its decision would help spur the deployment of broadband at affordable prices. However, Verizon and BellSouth both opted not to pass those savings on to consumers. Instead, Verizon announced plans in August, 2006 to charge a "supplier surcharge" and BellSouth announced plans to impose a "regulatory cost recovery fee" in the place of the universal service fee.[106] After public outcry and statements by the FCC that it would investigate the actions of the carriers, these two Bells capitulated and announced plans to drop the fees.[107] The episode illustrates why consumer advocates and regulators have important oversight roles and why competition alone does not provide pricing discipline.

In August 2006, Verizon's lowest priced DSL offering (with speeds up to 768 Kbps) was $14.99. However, after dropping its "fee" Verizon apparently simply later

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[105]/ *FCC Verizon/MCI Merger Order*, at note 296. The Commission also stated, "[m]oreover, these strategies are revealed in their marketing." *Id.*, citing, Verizon Second Quarter 2005 Earnings Conference Call at 6, wherein it was stated: "In consumer, our approach to the marketplace is to focus on customer retention and loyalty, while increasing the average monthly revenue per customer through these new services and higher penetration of bundles and packages."

[106]/ Amy Schatz, "Verizon and BellSouth DSL Users Won't See Lower Bills as Fee Ends," *The Wall Street Journal*, page A2, August 22, 2006.

[107]/ Federal Communications Commission, News Release, "Statement of FCC Chairman Kevin Martin on Verizon and BellSouth Eliminating Recently Imposed DSL Fees," August 30, 2006; Verizon, News Release, "Verizon Removes DSL Supplier Surcharge," August 30, 2006.

raised its monthly rates. Verizon is currently offering this service for $19.99.[108] Verizon has been able to sustain a rate increase while, as Figures 4 and 10 show, still attracting and retaining customers.

2.6. The level and type of competition that customers experience vary.

While the telephone and cable companies appear to be poised to compete head-to-head nationwide and in New Jersey, the extent to which each company will enter the other's traditional market (*i.e.*, telephone companies entering the video market and cable companies entering the voice market) will vary. Competition, even duopolistic competition, will vary by product market, geographic market, and customer class.

As the previous section discusses, it is unlikely that telephone and cable companies will compete with each other except in the bundled services market (and even in that market, the duopoly incentive will temper the competition). Not all consumers seek all products. Carriers compete more aggressively to sell lucrative triple-play packages, and, although they may not compete on price, they may compete on the basis of product differentiation. The benefits of competition in the cable market from the telephone companies entering will likely accrue almost entirely to customers of bundled services, with Verizon primarily providing video services as part of a bundle of services. Verizon is unlikely to offer what is traditionally thought of as "basic" cable.

The experience of cable companies entering the voice market illustrates this point well. The cable companies' voice offerings are usually more expensive than a single, local wireline connection. In order to qualify for a rate that is more comparable (yet, still higher than) an average wireline rate, cable telephony customers typically must also subscribe to an entire bundle of services they may not need or desire.[109] A basic cable subscription from the local cable company, with access to local television stations, but no bells and whistles, will probably prove to be less expensive than an IPTV offering. Yet, competition from IPTV may not provide price constraints and the cable company will be able to raise prices for basic service while still undercutting the IPTV price.

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[108] / This rate is introductory and requires a 12-month commitment. Details available at http://www22.verizon.com/content/consumerdsl/plans/all+plans/all+plans.htm (accessed January 16, 2006). AT&T customers in 22 states can now subscribe to DSL at the same speed for only $10.00. AT&T has made the following commitment: "Within six months of the Merger Closing Date, and continuing for at least 30 months from the inception of the offer, AT&T/BellSouth will offer to retail consumers in the Wireline Buildout Area, who have not previously subscribed to AT&T's or BellSouth's ADSL service, a broadband Internet access service at a speed of up to 768 Kbps at a monthly rate (exclusive of any applicable taxes and regulatory fees) of $10 per month." Letter from Robert W. Quinn, Jr., Senior Vice President Federal Regulatory, AT&T to Ms. Marlene H. Dortch, Secretary, Federal Communications Commission, Re: Notice of *Ex Parte* Communications *In the Matter of Review of AT&T Inc. and BellSouth Corp. Application For Consent to Transfer of Control*, WC Docket No. 06-74, December 28, 2006 ("AT&T/BellSouth Merger Conditions").

[109] / *See* footnote 103, supra.

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Likewise, the cable company will have the incentive to raise prices for services in rural or poor areas where the telephone company's video offering is not yet available and thus subsidize discounts and offers extended to subscribers in the more competitive regions. Similarly, the phone company will have the incentive to subsidize its video deployment in wealthy areas and to attract the "high value" customer with revenues from noncompetitive services.

Although the addition of a competitor in the cable market is to be applauded, regulators should continue to monitor the market because a cable-telco duopoly is not sufficient to provide effective competition and the telco and cable competitors are indisputably still dominant carriers in their respective non-bundled markets. A range of competition exists across markets and regulators still must address the reality that both cable and phone companies may operate as monopolies in some segments of the market. Chapter 3 addresses the incentives and manner in which carriers are able to cross-subsidize and leverage monopoly positions in their respective traditional markets.

3. INCUMBENT CABLE AND TELECOMMUNICATIONS COMPANIES HAVE THE INCENTIVE TO ENGAGE IN IMPROPER CROSS-SUBSIDIZATION

3.1. Introduction.

In a world in which companies increasingly integrate and promote “bundles” of diverse technologies, requirements for accounting and accountability may seem arcane. Indeed, if the product market was competitive, that is, if there were no dominant carriers capable of exerting market power, proposals for accounting and structural separations, and many other regulatory proposals, would be superfluous. However, as this paper demonstrates, a number of the underlying components of the product bundles that Verizon, Cablevision, Comcast, and other cable companies advertise and sell are not yet competitive.

Cable companies are leveraging their unique dominance in the cable television market to offer services that once were the exclusive domain of telephone companies. In turn, Verizon is using its unique dominance in the telecommunications market to offer services that once were the exclusive domain of cable companies. Section 3.2 describes generally the ways in which these industries are entering each others’ traditional markets. Because each of these industries relies on substantial shared common resources and plant to enter new markets, and because each industry dominates its respective market in the provision of basic service, significant opportunities for improper cross-subsidization abound.

3.2. Cable and telecommunications companies rely on extensive common resources and facilities to bring both “traditional” and “state-of-the-art” products to market.

That cable and telecommunications companies are seeking to offer more services over their networks is indisputable. Companies like Verizon that traditionally concentrated on voice service first expanded their service offerings to include Internet access over copper wire. The increasing importance of the Internet, consumers’ demand for greater speed while online, and the emerging threat from cable companies eventually provided the impetus for telephone companies to deploy fiber optic technology in order to reach the homes and businesses of users more effectively.[110] The increased capacity provided by fiber technology allowed traditional “voice” companies to refocus their

[110] / *See* Appendix 2.

business strategies, first toward data, and now, toward the bundle of voice, data, and television services.

Verizon New Jersey and its corporate parent are providing these new services over plant once used exclusively for voice service and are devoting personnel and resources to these new services, it once focused primarily on intrastate regulated operations. Verizon New Jersey's November 2006 application to the Board for a system wide cable franchise asserted that Verizon New Jersey was "not seeking authority … to construct the FTTP [fiber to the premises] Network, but rather . . . seeking the authority to provide cable television service pursuant to a system wide franchise under N.J.S.A. 48:5A-15."[111] On the other hand, Verizon New Jersey characterized its video deployment as simply an upgrade of "substantial portions of its telecommunications network with FTTP technology as a common carrier," and stated further, "[a]s such, the construction being performed in the public rights of way is being undertaken pursuant to Verizon NJ's authority as a telecommunications service provider."[112] Clearly, in addition to relying on its new fiber network for the rollout of FiOS TV, Verizon also intends to utilize portions of its existing network for the provision of new services.

Likewise, the cable industry once focused exclusively on the provision of television services. However, the ubiquity of the industry's network allowed transformation of the cable infrastructure into a system for providing data service – in particular, access to the Internet – to homes in the existing cable systems' footprint. Today, as the idea of convergence takes hold, the cable industry sees the same opportunity as the telephone companies – the opportunity to provide *all* the telecommunications, information services, and entertainment that households require, and thus maximize its revenue per connection. As Cablevision states in an earnings release, it offers:

> Telecommunications Services includ[ing] Cable Television – Cablevision's "Optimum" branded video, high-speed data, and voice residential and commercial services *offered over its cable infrastructure* -- and its "Optimum Lightpath" branded, *fiber-delivered commercial data and voice services*.[113]

Comcast states that it is "principally involved in the development, management and operation of *broadband cable networks* and in the delivery of programming content."[114] Comcast does not refer to separate networks for video, information, and voice. It is clear the Comcast, and, indeed, most if not all of the cable and telecommunications companies, are sharing resources among business segments.

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111 / Verizon Franchise Application, at 9.

112 / *Id.*, at 18.

113 / Cablevision Systems Corporation, "Cablevision Systems Corporation Reports Third Quarter 2006 Results," November 8, 2006, at 2 (emphasis added).

114 / Comcast Corporation, "presskit_121506.pdf," available at www.comcast.com, at 1 (emphasis added).

3.3. Implications for consumers.

The implications of shared resources and facilities for consumers are far reaching. Consumers of one service, for example, basic telephone service, are implicitly financing the expansion of the telco business to support video. Similarly, the customer of basic cable television service is supporting the technology development, marketing, and administration of voice service over the cable facilities. Although the additional cost may be obscured from most individual consumers, the aggregate effect over all consumers is enormous.

In addition to the fact that consumers are forced to pay for services that many do not receive (either because products are unavailable in their area, they cannot afford the product, or do not want the product), the implicit subsidization removes important economic signals from the market. Basic business economics suggests that a project is worth undertaking only if it pays for itself. And yet, Verizon New Jersey states that financing for its cable offering comes from "internally generated funds."[115] This suggests that financing to deploy and promote video service comes from its base of traditional customers, many of whom will never benefit from Verizon video offerings. Instead, stockholders should be bearing the risk for new ventures. The same concern applies to cable's foray into voice service. The key question is, "Who is paying for this new service?"

3.4. Verizon recently obtained statewide franchising authority.

On December 15, 2006, the Board approved Verizon New Jersey's application and granted Verizon New Jersey the state's first systemwide cable television franchise,[116] made possible by legislation enacted in August 2006.[117] Prior to this legislation, companies intending to provide cable service were required to negotiate franchise rights with each municipality on an individual basis. The legislation paved the way for Verizon to seek authority to offer cable services to 316 municipalities throughout the state.[118]

Among other things, as noted by the Board, Rate Counsel "had a number of factual questions as to the information provided by the applicant, including . . .

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115 / Verizon Franchise Application, at 22.

116 / *Verizon Systemwide Cable Television Franchise Order*.

117 / On August 4, 2006, Governor Corzine signed cable franchise legislation A-804/S-192. State of New Jersey Office of the Governor, Press Release, "Governor Corzine Signs Cable Franchise Legislation and Executive Order," August 4, 2006.

118 / New Jersey Board of Public Utilities, "New Jersey Board of Public Utilities Approves First Systemwide Cable Franchise in the State," available at http://www.bpu.state.nj.us/home/news.shtml?44-06.

interaction between the regulated telephone business entity and the cable operating business entity."[119] The Board determined that the legislation did not enable the Board to grant a provisional franchise, as recommended by Rate Counsel, but stated that:

> The Board intends, however, to condition any grant of a franchise on appropriate and necessary conditions that must be met for VNJ to remain in compliance with the franchise, and it is the Board's belief that this approach both satisfies the legal mandate provided to the Board and allows for the type of continuing oversight that the Public Advocate, as well as the Board, considers proper for this or any other franchise, and which is in keeping with past Board action.[120]

The Board also addressed the federal requirement that cable service providers be exempted from rate regulation if a local exchange carrier offers video services in the franchise area of an unaffiliated cable operator. The Board stated that it "is aware that VNJ is subject to effective competition," and that "[t]here would be no value, and it would require the Board to ignore the basic facts, for the Board to assert rate regulation over VNJ."[121] However, as Chapter 2 demonstrates, contrary to the Board's discussion, the presence of an incumbent cable operator does not provide sufficient competition. Therefore, structural separations, clear accounting, and regulatory oversight of Verizon NJ's allocation of costs to its cable operations are essential. Neither the legislation nor the Board's Order address the significant opportunity for improper cross-subsidization created by Verizon's entry into the cable business.

3.5. Verizon New Jersey's FiOS application.

Verizon New Jersey's cable franchise application provides some detail about its plans for video deployment in New Jersey, but asserts that many important details regarding its plans, particularly those related to identification of particular communities planned for deployment, are confidential.[122] In its application, Verizon states that it intends to begin providing commercial cable television service to some of the municipalities listed in Exhibit B (a confidential exhibit not included in the public version of Verizon's application) within three years of the date of issuance of a systemwide cable franchise in New Jersey. The company plans to make cable television service available throughout all of the municipalities listed in the confidential exhibit within six years of issuance of the franchise.[123]

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119 / *Verizon Systemwide Cable Television Franchise Order*, at 5.

120 / *Id.*, at 9.

121 / *Id.*, at 14. *See*, also, *Id.*, at 13, citing 47 C.F.R. §79.905.

122 / As noted in the *Verizon Systemwide Cable Franchise Order*, at footnote 2, the Division of Rate Counsel has been provided the full non-redacted application under a confidentiality agreement in Docket No. CE06110768. This paper relies on the redacted version of the Application.

123 / Verizon Franchise Application, at 1.

INCUMBENT CABLE AND TELECOMMUNICATIONS COMPANIES HAVE THE INCENTIVE TO ENGAGE IN IMPROPER CROSS-SUBSIDIZATION

Verizon Communications is pursuing cable television franchises in many communities throughout the country. At the time of the Application, Verizon held 190 cable franchises covering approximately three million households in New York, Virginia, Maryland, Texas, Massachusetts, California, Florida, Pennsylvania, and Delaware. FiOS TV is currently available to approximately 100 communities in Verizon's operating territory. Verizon reports that the average penetration rate for FiOS TV after six months of marketing is approximately ten percent.[124]

As previously noted, Verizon describes its application as "not seeking authority … to construct the FTTP Network, but rather … seeking the authority to provide cable television service pursuant to a system wide franchise under N.J.S.A. 48:5A-15."[125] Verizon further cites section 15 of the systemwide franchise legislation (*N.J.S.A*. 48:5A-15), stating: "telecommunications service providers currently authorized to provide service do not require approval to upgrade their facilities that may be used in connection with the provision of cable television service."[126]

Verizon's application characterizes the fiber used to provide cable television service as single mode cable with 12 to 864 fibers,[127] and states that its service will be delivered to the premises via the FTTP telecommunications network.[128] Although the application requires a map showing the proposed service area of the franchisee, Verizon states that inclusion of such a map is unnecessary because the FTTP facilities being utilized are authorized under Title II of the Communications Act and Chapter 17 of New Jersey's *N.J.S.A*. 48:1.2 et seq. Nevertheless, the company provides a list of affected municipalities in Exhibit N to its Application, which it deems to be confidential.[129]

Verizon refers to Confidential Exhibit R to its application for details concerning financing of the rollout of FiOS TV service. This exhibit also purportedly provides projections of revenues, cash flow, and expenditures. However, the company later explains that it "intends to finance the construction of the FTTP system and the provision of cable services through a variety of internally generated funds."[130]

Based upon Rate Counsel review, the information that Verizon provided to the Board does not include sufficient information to enable the Board to detect and to deter improper cross-subsidization. As Rate Counsel stated, "[t[hese rules must propose and include sufficient safeguards to preclude cross subsidization of services and appropriate

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124 / *Id.*, at 8.

125 / *Id.*, at 9.

126 / *Id.*, at 18.

127 / *Id.*, at 15.

128 / *Id.*, at 16.

129 / *Id.*, at 15.

130 / *Id.*, at 22.

safeguards that ensure the continued safe, and adequate cable service for New Jersey residents at just, reasonable, and affordable rates."[131]

3.6. Structural separations is needed to prevent Verizon from deploying video and other new services "on the backs of" consumers.

3.6.1. Verizon's and the cable industry's access to a ubiquitous network of customers gives them ample opportunity to engage in improper cross-subsidization.

The Bells' DSL deployment shows that incumbents possess the incentive and ability to assign and allocate common costs to consumers and to retain revenues for shareholders. Verizon's successful DSL sales yield the company substantial profits, in large part, because, as a result of the under-assignment of common costs to this line of business, DSL gets a "free ride" over the basic loop component of Verizo's ubiquitous copper network. More generally, basic services are a "cash cow" to fund Verizon's forays into new lines of business.

Table 2 shows that Verizon generates between \$100,000,000 and \$500,000,000 per year from its DSL operations in New Jersey.[132] However, Verizon likely assigns and allocates minimal costs of common plant and resources to this line of business. The consequence of this revenue-cost mismatch is that shareholders benefit from high profits, and consumers of basic services pay high rates.

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[131] / Remarks of Seema M. Singh, Esq., Director, Division of Rate Counsel presented by Christopher J. White, Esq., Deputy Public Advocate, *In the Matter of the Board's Regulation of Cable Television, Proposed Readoption with Amendments: N.J.A.C. 14:18 and Proposed New Rules: N.J.A.C. 14:18-14 and 15*, Docket Nos. CX06030141 and CX06080580, Proposal Number: PRN 2006-384, Public Hearing, Board of Public Utilities, Newark, New Jersey, January 4, 2007.

[132] / Data on Verizon New Jersey's DSL customer base and revenues are not publicly available. Because Verizon New Jersey serves the vast majority of New Jersey, Table 2 relies, for one estimate, on the total number of DSL connections for New Jersey reported in the FCC's High-Speed Services July 2006 Report, at Table 11 as a proxy for the number of connections provided by Verizon New Jersey. As of December 31, 2005, this number was 540,382. The second estimate is based on the fact that Verizon's switched access lines in New Jersey represent 11.3% of all of Verizon's switched access lines. The ratio of 11.3% is multiplied by total Verizon DSL connections as of September 30, 2006. (Sources: Total Verizon Switched Access Lines: Verizon Communications, Investor Quarterly: VZ Q4 2005 Investor Quarterly, page 13; Verizon New Jersey Switched Access Lines: FCC, Selected RBOC Local Telephone Data, as of December 31, 2005; Total Verizon DSL Connections: Verizon Q3 2006 Investor Quarterly, page 14; Monthly DSL Rates: Verizon website (http://www22.verizon.com/content/consumerdsl/plans/all+plans/all+plans.htm and http://www22.verizon.com/content/businessdsl/packages+and+prices/packages+and+prices.htm), accessed 1/15/2007.))

Table 2
DSL Generates Substantial Revenue for Verizon New Jersey
(Annual)

	Monthly Rates		**Annual VNJ DSL Revenues**	
Number of Connections	Lowest Rate	Highest Rate	Low Estimate	High Estimate
540,382	$19.99	$59.99	$129,626,834	$389,010,194
739,761	$19.99	$59.99	$177,453,869	$532,539,149

Note: This table includes two estimates of the total number of DSL connections. The first estimate corresponds with all DSL connections in New Jersey as of December 31, 2005. The second estimate is based on Verizon's company-wide DSL lines as of September 30, 2006 and an estimate of New Jersey's share of those lines. The number of DSL connections is multiplied by the highest and lowest advertised monthly rates, times 12, to arrive at estimates of annual DSL revenue for Verizon New Jersey.

3.6.2. Verizon's FiOS venture may prove profitable in the future, however, the Board should determine whether the "internally generated funds" Verizon is currently using to finance its FiOS business venture are coming from regulated operations.

Verizon began rollout of its FiOS fiber network in 2004, and by the end of 2005, the network passed 3 million homes in 800 communities.[133] As of the end of the third quarter of 2006, Verizon's FTTP network passed a total of 5.3 million homes. Furthermore, Verizon has seen a steady increase in demand for the products that it provides over the FiOS network. As of the third quarter of 2006, penetration rates for FiOS Internet service and FiOS TV reached 14%, and 10%, respectively.[134] FiOS Internet customers totaled 522,000 at the end of the third quarter of 2006 and FiOS TV customers totaled 118,000.[135]

Verizon added 448,000 net new broadband connections in the third quarter of 2006 for a total of 6.6 million broadband connections, an increase of 45.1% from the third quarter of 2005.[136] FiOS Internet customers represented 147,000 of the net new

[133] / Verizon 2005 Annual Report, at page 6.

[134] / Verizon Communications, *Investor Quarterly: Third Quarter 2006*, October 30, 2006, at page 5.

[135] / *Id.*, at page 3.

[136] / *Id.*, at 2.

broadband connections in the third quarter and as of the end of third quarter 2006, Verizon reported 522,000 FiOS Internet customers. Additionally, Verizon reported 118,000 FiOS TV customers at the end of the third quarter of 2006.[137]

Verizon clearly views this as just the beginning of the FiOS era. A Verizon executive told Wall Street analysts in September 2006:

> We will meet our 6 million [homes passed] objective by the end of the year. We will open 5 million premises for sale on the data side . . . You can see the end-of-period [year 2010] objective there -- 18 million homes passed. And also, that would be about 50% of our households.[138]

Verizon predicted that it will achieve 35-40% penetration of the households passed by their FiOS network for data, and 25% penetration for video, by 2010.[139]

Although Verizon's video deployment is still in the early stages, it appears to have already achieved notable success. Verizon began offering video service over FiOS in three markets in 2005. The Keller, Texas area was the first FiOS video market, and the video penetration rate was 21% after only four months.[140] Before entering New Jersey markets, Verizon counted more than 230 franchise areas, covering approximately 5 million households in 10 states.[141] Verizon estimated a 10% penetration rate for its FiOS TV offerings across all of its markets.[142]

Table 3 summarizes Verizon's present rates for its FiOS-based services. Although FiOS offers speeds much faster than the speed of its DSL service, the FiOS rate is also much higher than DSL rates. As Table 3 shows, consumers pay $39.95 for stand-alone FiOS-based access to the Internet. By comparison, Verizon's DSL-based Internet is $19.95,[143] and AT&T's new DSL rate is $10.00.[144]

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[137] / *Id.*, at 3.

[138] / Verizon FiOS Briefing Session, at page 4.

[139] / *Id.*, at page 11.

[140] / Verizon 2005 Annual Report, at page 15.

[141] / Verizon News Release "TV as You've Never Seen It Before: Verizon Launches FiOS TV in Greater Philadelphia Area," December 4, 2006.

[142] / Verizon Communications, *Investor Quarterly: Third Quarter 2006*, October 30, 2006, at 5.

[143] / *See* Appendix 2.

[144] / *AT&T/BellSouth Merger Conditions.*

Table 3
Rates for FiOS Services

FiOS Internet Service	Monthly Rates	
For Internet Access Speeds Up To: (downstream/upstream)	Stand-Alone	Part of a Package
5 Mbps/2 Mbps	$39.95	$34.95
15 Mbps/2 Mbps	$49.95	$44.95
30 Mbps/5 Mbps	$199.95	$179.95
FiOS TV Premier Package		$42.99
Set Top Box Options		
Standard Definition		$4.99
High Definition, with HD Channels		$9.99
Dual-tuner, HD-Capable Digital Video Recorder		$12.99
FiOS Bundle		
FiOS TV, FiOS Internet, and Verizon Freedom Value Unlimited Calling Plan		$104.85

Sources: Verizon New Jersey website (http://www.verizonnj.com /fttp/NJ/Verizon_FiOS_Fact_Sheet.asp); Verizon News Release, “TV as You've Never Seen It Before: Verizon Launches FiOS TV in 106 New Jersey Communities,” January 11, 2007; Verizon News Release, “Verizon FiOS TV Comes to Lynn, Marlborough and Needham, Mass.,” December 12, 2006.

Although Verizon is successfully selling its FiOS-based services, FiOS is not yet profitable. Verizon Chief Financial Officer and Executive Vice President Doreen Toben stated “[w]e believe FiOS will result in sustainable profit growth for the business for years to come.”[145] She explained further that FiOS should reach positive EBITDA in its third year and positive operating income in its fourth year.[146]

The enormous development and deployment costs of FiOS presently act as a drain on Verizon’s income. Wireline offerings (both voice and data) and Verizon’s FiOS

[145] / Verizon FiOS Briefing Session, at page 3.

[146] / *Id.*, at page 25.

(Internet and TV) offerings are served out of the "Verizon Telecom" business unit.[147] In the third quarter of 2006, for example, Verizon's income dilution from FiOS data and video deployment was 9 cents per share. The full year estimate from this dilution was increased in the third quarter of 2006 from 28 to 30 cents per share to 31 to 32 cents per share.[148] There were approximately 2.9 billion shares at the end of Q3 2006,[149] which means the earnings dilution for 2006 is approximately $900 million.

Verizon's ambitious goal of running fiber to the premises is a costly endeavor.[150] According to Verizon executives, over seven years, the cost of deployment is expected to be approximately $22.9 billion. On a per home basis, this will average $817 to pass (running the fiber to the premises); $172 for development of the video network; and $718 to connect (making the physical connection of the premises to the network).[151] Verizon indicates, however, that the cost to run fiber to the home is reduced by the avoidance of running copper, which, according to Verizon, reduces the total deployment cost to about $1,400 per home passed, or about $2,500 per home connected.[152] Table 4 summarizes Verizon's estimates of its costs of its FiOS rollout.

Table 4
FiOS Rollout Costs Are Declining, But Still Substantial

	Cost To Pass	Cost To Connect
December 2005 (actual)	$1,021	$1,200
September 2006 (actual)	$845	$900
2010 (goal)	$700	$880

Sources: Thomson StreetEvents, Conference Call Transcript, Verizon FiOS Briefing Session, Sept. 27, 2006; Verizon *Investor Quarterly*, Third Quarter 2006, October 30, 2006, at page 5.

Furthermore, Verizon is pursuing the Cadillac fiber deployment plan. In comparison with Verizon's plan (which one article estimates to be $18 billion over six

147 / Verizon Communications, *Investor Quarterly: Third Quarter 2006*, October 30, 2006, at 3.

148 / *Id.*, at page 5.

149 / *Id.*, at page 7.

150 / By contrast, AT&T is opting for a far less expensive option of deploying fiber to the neighborhood. "Whitacre's Way," Dennis Kneale, *Forbes*, January 8, 2007, at 84-88.

151 / Verizon FiOS Briefing Session, at page 24.

152 / *Id.*, at page 24.

years to cover 18 million homes by the year 2010, "digging up trees and tulips to lay fiber to each and every home"), AT&T is estimated to spend only $4.6 billion to reach 19 million homes by 2008 by bringing fiber into neighborhoods and relying on existing copper phone lines for the last "leg" to households.[153]

Although the decision to deploy a costly fiber network clearly resides with Verizon management, the responsibility to ensure that consumers are not bearing the risk or cost of Verizon's decision resides with the Board. Without adequate safeguards, consumers will bear the brunt of Verizon's ambitious capital investment. Furthermore, the FiOS plans can harm consumers as employees shift their focus from the more mundane task of providing basic telephone service to the deployment of new services and the sales, marketing, customer service, and technical needs related to those services. Board oversight of quality of service has become more important than ever.[154] Furthermore, without comprehensive accounting by Verizon, the Board cannot ascertain whether FiOS would be profitable if Verizon assigned and allocated a fair share of common resources and plant to this new line of business.

3.7. Verizon's bundling strategy now encompasses DSL-based and FiOS-based platforms, which depend critically on resources shared with its local operations.

The Bells' increasing focus on broadband and video increases the incentive for cross-subsidization of new ventures with monopoly revenues. The pattern with DSL is instructive as one considers the implications of Verizon's entry into cable business. In 2000, DSL connections comprised only 1% of total connections nationwide (where total connections are defined as the sum of switched access lines and DSL connections). By 2005, this "DSL ratio" reached 12%.[155] The ultimate penetration of DSL depends on Bell's deployment plans, customer preference for alternative technologies (*e.g.,* cable modem),[156] and the Bells' success in encouraging DSL customers to migrate to the Bells' new fiber-based alternatives.

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[153] / "Whitacre's Way," Dennis Kneale, *Forbes*, January 8, 2007, at 86. *See* generally, 84-88.

[154] / *See* Section 3.10 following.

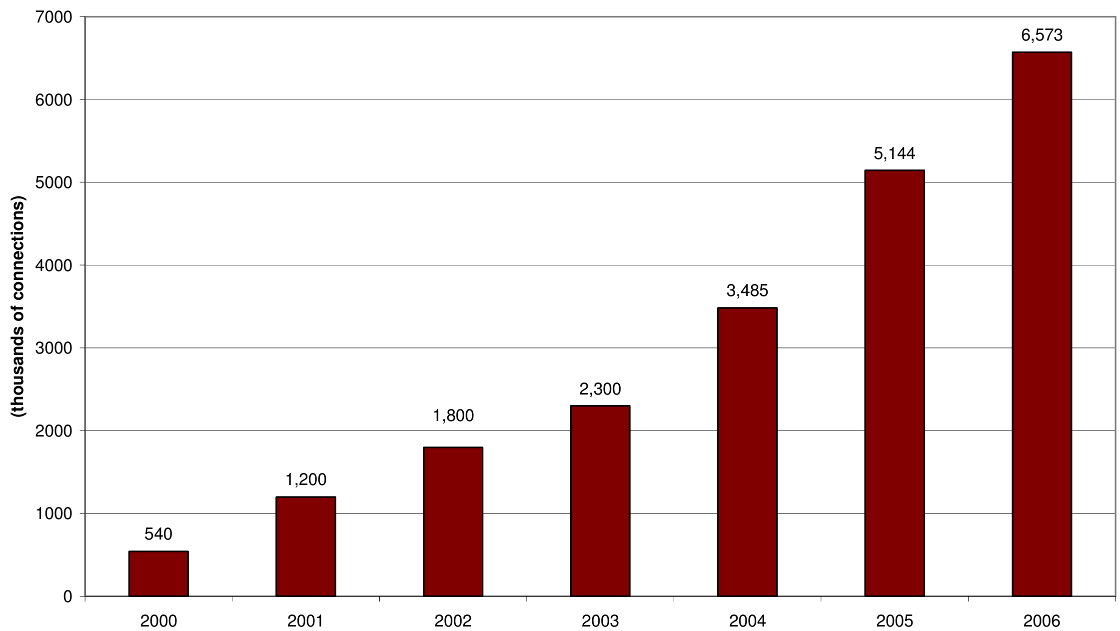
[155] / Switched Access Lines: ARMIS Report 43-08, Table III. "Access Lines in Service by Customer," Row 910. DSL Connections: SBC 2004 Annual Report, page 5; AT&T 2005 Annual Report, page 18; BellSouth 2004 Annual Report, page 26; BellSouth 2005 Annual Report, page 34; Qwest 2002 Annual Report, page 37; Qwest Historical Financial Information, As of December 31, 2005, tab "Wireline" (QstatisticalProfile4Q05.xls, available at www.qwest.com); Verizon Q4 2000 Investor Quarterly, page 5; Verizon 2005 Annual Report, page 13.

[156] / According to the FCC's latest high speed services data, consumer DSL subscriptions grew by 5.7 million lines in 2005 compared to a growth of 4.2 million lines for consumer cable subscriptions. The cable industry percentage of high-speed lines dropped 3.5%, while the DSL share of high-speed lines grew 3.3% to reach 40.5%. *FCC High-Speed Services July 2006 Report*, at 2.

INCUMBENT CABLE AND TELECOMMUNICATIONS COMPANIES HAVE THE INCENTIVE TO ENGAGE IN IMPROPER CROSS-SUBSIDIZATION

The following bar chart shows the growth of Verizon's DSL customer base over seven years.

Figure 4
Demand for Verizon DSL Increased More than 1,000% in Six Years



Note: Figures are nationwide in scope. Sources: Verizon Q4 2000 Investor Quarterly, page 5; Verizon Q4 2002 Investor Quarterly, page 5; Verizon 2005 Annual Report, page 13; Verizon Q3 2006 Investor Quarterly, page 2.

DSL may be Verizon's strategic stepping stone to other platforms to support its entry into video services, which it seeks to offer in "competition" with cable companies.[157] By locking in customers to DSL-based services, Verizon can then more easily encourage the same customers to migrate to higher-revenue fiber-based video offerings. Proper cost accounting is essential to ensure that Bells compensate customers of local intrastate regulated services adequately for the invaluable use of their embedded customer base. Verizon's ability to offer DSL depends critically on its ubiquitous local loop infrastructure. Verizon's ability to offer cable depends critically on its historic status as the state's incumbent local exchange carrier, and associated infrastructure, corporate resources, and expertise. Furthermore, the FCC's decision to decline to require Verizon and other Bells to provide unbundled fiber to competitors[158] is another reason that Verizon should conduct its new lines of business separately from its intrastate regulated operations.

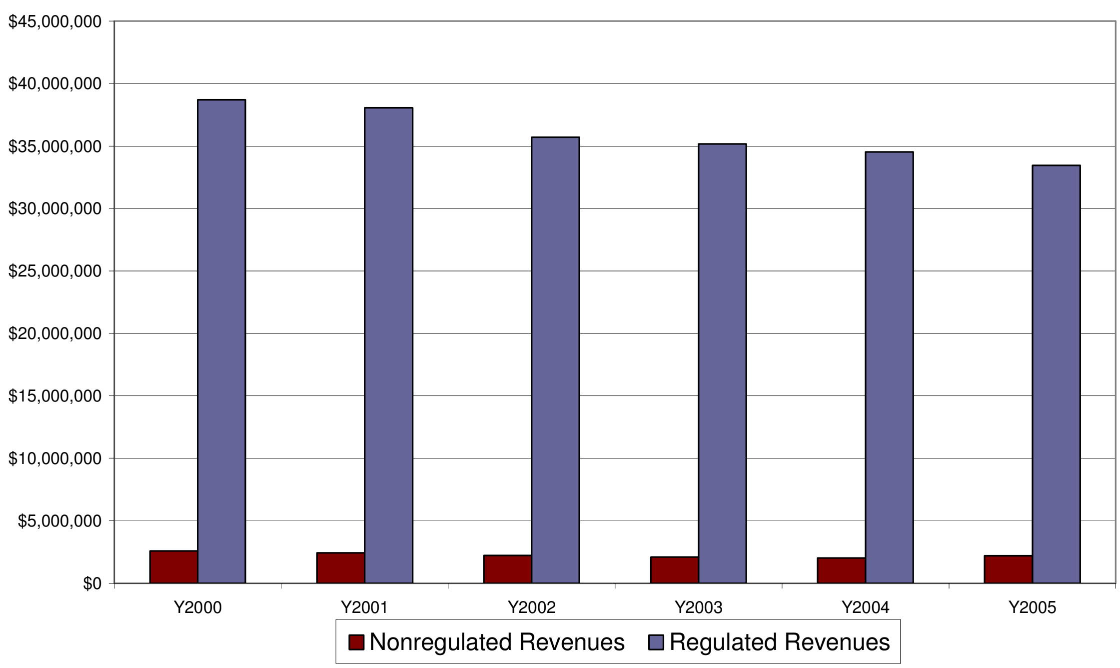
[157] / The purported "competition" is negligible since consumers confront a cable-telco duopoly.

[158] / *Wireline Broadband Order*, at para. 87.

3.8. Verizon enjoys a substantial stream of revenues from noncompetitive services, which provide a virtually risk-free source of monies to enter new lines of business.

Verizon's noncompetitive services provide a substantial, steady stream of revenues. Figure 5 shows that Verizon derives substantial revenues from its regulated operations, which provide it with a substantial opportunity and incentive to cross-subsidize improperly its multi-billion dollar FiOS deployment and its entry into the cable business.[159]

Figure 5
Revenues from Verizon's Regulated Services Are at Risk of Funding Verizon's New Products



Source: FCC ARMIS Report 43-01, Table I, Rows 1045 and 1090, accessed 1/15/1007.

The substantial stream of revenues shown in Figure 5 is especially important given the costly nature of FiOS deployment. Although FiOS is expected to become a cash cow for Verizon, it consumed approximately $900 million of Verizon's cash in

[159] / The magnitude of the unregulated revenues is largely unchanged over the six-year period depicted in Figure 5, which suggests that the category may not include its growing DSL revenues and, furthermore, that more comprehensive cost accounting reports to the FCC may be necessary.

2006.[160] Access to the revenues from its regulated operations and its enviable ranking as the second largest telecommunications company in the country provide Verizon with the opportunity to cross-subsidize new ventures. In many areas, including New Jersey, Verizon has a near monopoly on local service. As Chapter 2 describes, Verizon dominates New Jersey's local markets.

3.9. Improper cross-subsidization harms consumers by distorting rates.

Firms that offer both noncompetitive and competitive services possess the economic incentive to cross-subsidize the services that confront relatively more competition with those that confront minimal or no competition. The cross-subsidization can take the form of misaligned prices: firms have the incentive to over-price monopoly services because customers have little recourse, and to under-price services which face relatively more competitive pressure, in order to attract and retain customers who might otherwise migrate to alternative suppliers. The cross-subsidization can also take the form of selective levels of service quality, with a firm devoting disproportionate resources to the service in the relatively more competitive market.[161] Finally, directly related to the mis-aligned prices, carriers can under-assign and under-allocate costs to the more competitive products, and recover joint and common costs disproportionately from the monopoly offerings.

Although the focus of this paper is on telco-cable cross-entry, even within the telecommunications market, Verizon can exercise its market power to cross-subsidize products. For example, Verizon offers unlimited Directory Assistance ("DA") as part of its bundled offerings, but charges on a measured basis to all other residential customers.[162] Similarly, Verizon charges monthly rates ranging between $2.30 and $4.59 for custom calling services, but includes these same features with no explicit charge as integral components of its "Freedom" packages.[163] The bundled offerings seek to attract

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160 / Verizon Communications, *Investor Quarterly: Third Quarter 2006*, October 30, 2006, at pages 5 and 7.

161 / For example, Verizon told Wall Street analysts in October 2006: "Our goal is to offset FiOS expenses with reductions in the core business . . . Going forward, we continue to see significant opportunities for wireline cost savings. VZ – Q3 2006 Verizon Earnings Conference Call, October 30, 2006, Thompson Financial, Final Transcript available at http://investor.verizon.com/news/20061030/3q06_vz-transcript.pdf, at 3.

162 / Rate Counsel has raised the issue of unlimited DA being provided in Freedom packages in the Board's pending investigation of the classification of DA. *In the Matter of the Board's Review of the Classification of Verizon New Jersey's Directory Assistance Services ("DAS") as Competitive and Associated Service Quality; In the Matter of the Filing of Verizon New Jersey Inc. for the Reclassification of Existing Rate Regulated Services – Directory Assistance Services as Competitive Services*, BPU Docket Nos. TX06010057; TT97120889.

163 / Custom Calling Services include Speed Dialing, Three-Way Calling, Call Forwarding, Talking Call Waiting and Call Waiting. Verizon New Jersey, Inc. Tariff B.P.U.-N.J. No. 2 Exchange and Network Services, Tenth Revised page 59, Issued October 22, 2004, Effective November 22, 2004.

customers whose demand is more price elastic and who are more likely to migrate to cable companies. As another example, Verizon's successful DSL sales (see section 3.6.1 above and Appendix 2) yield the company substantial profits, in large part, because, as a result of the under-assignment of common costs to this line of business, DSL gets a "free ride" over the basic loop. Without a reckoning of the allocation of Verizon's shared and common costs among services, one cannot detect whether basic services are cross-subsidizing services that confront relatively more competition. In the context of cable franchising regulation, the issue is the degree of cross-subsidization of entry into cable businesses.

Similarly, as cable companies in New Jersey seek to break into the telephone market, traditionally supplied by Verizon, they have the incentive to use monies from traditional cable products to cross-subsidize their new telecommunications ventures.

3.10. Improper cross-subsidization harms consumers through the deteriorating quality of basic service.

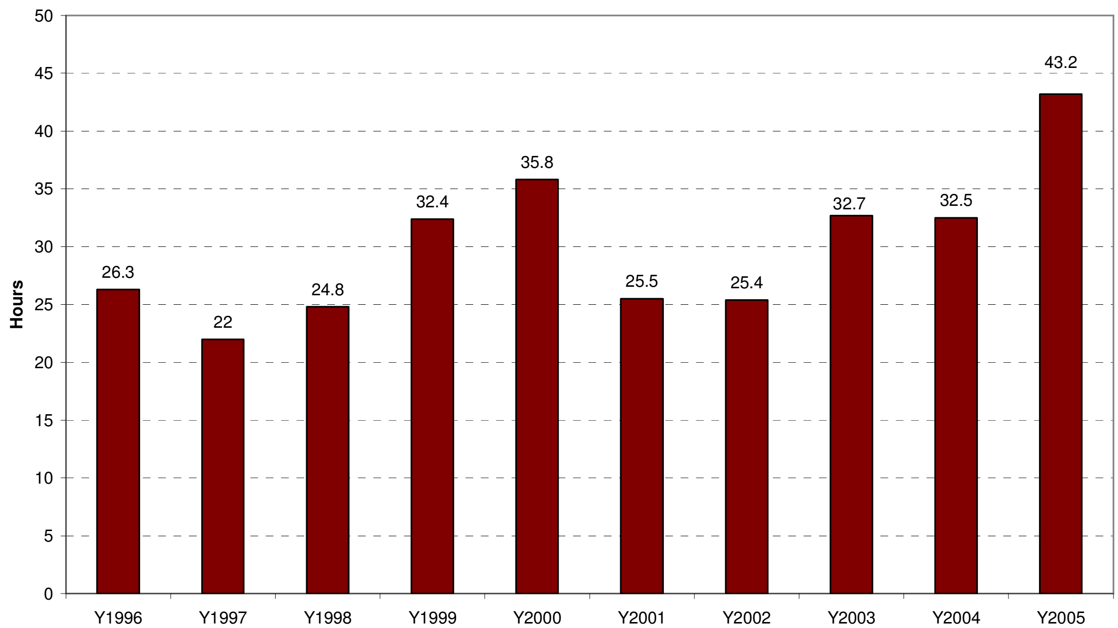
3.10.1.1. Cable and FiOS plans will likely exacerbate the deterioration of Verizon New Jersey's basic telephone service quality.

Verizon and the cable industry possess the economic incentive and the opportunity to offer higher quality of service to customers of new, unregulated products than to customers of regulated and/or noncompetitive products. Specifically, corporate management has the incentive to allocate resources to the triple and quadruple play customers rather than to customers of basic telephone and basic cable service.

Figure 6 shows that the quality of basic telephone service, as measured by the timeliness of Verizon's repair of basic dial tone service, has deteriorated in recent years in New Jersey. The "Initial Out-of-Service Interval" refers to the average duration (in hours) that a customer must wait for telephone service to be restored when there is a service outage: the longer the wait, the worse the performance. The following figure shows that Verizon New Jersey's Initial Out-of-Service Interval lengthened in recent years, reflecting a decline in service quality: The 2005 figure, at 43.2 hours, is almost *twice* the 1997 figure.[164]

[164] / FCC Report 43-05 ARMIS Service Quality Report, Table II. Installation and Repair Intervals (Local Service), Row 145, Accessed 1/12/2007. The most recent period for which ARMIS data is available is year-end 2005.

Figure 6
Verizon New Jersey's Service Quality Is Declining
(Initial Out-of-Service Interval: Residential Customers)

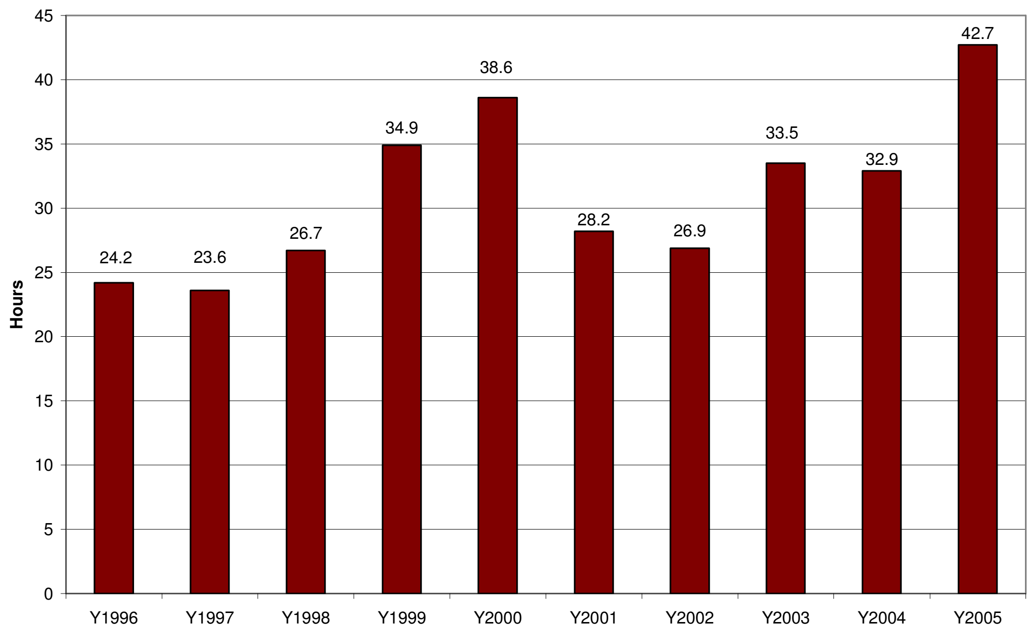


Source: FCC Report 43-05 ARMIS Service Quality Report, Table II. Installation and Repair Intervals (Local Service), Row 145, Accessed 1/12/2007.

Analysis of "Repeat Out-of-Service Intervals" for Verizon New Jersey shows a similar deterioration of basic telephone service quality over time. The Repeat Out-of-Service Interval refers to the length of time it takes for the telephone company to repair basic service that had an initial unsuccessful repair attempt. Figure 7 shows that the average Repeat Out-of-Service Interval in 2005, at 42.7 hours, was almost 60% longer than just three years earlier.[165]

[165] / FCC Report 43-05 ARMIS Service Quality Report, Table II. Installation and Repair Intervals (Local Service), Row 149, Accessed 1/12/2007.

Figure 7
Verizon New Jersey's Service Quality Is Declining
(Repeat Out-of-Service Interval: Residential Customers)



Source: FCC Report 43-05 ARMIS Service Quality Report, Table II. Installation and Repair Intervals (Local Service), Row 149, Accessed 1/12/2007.

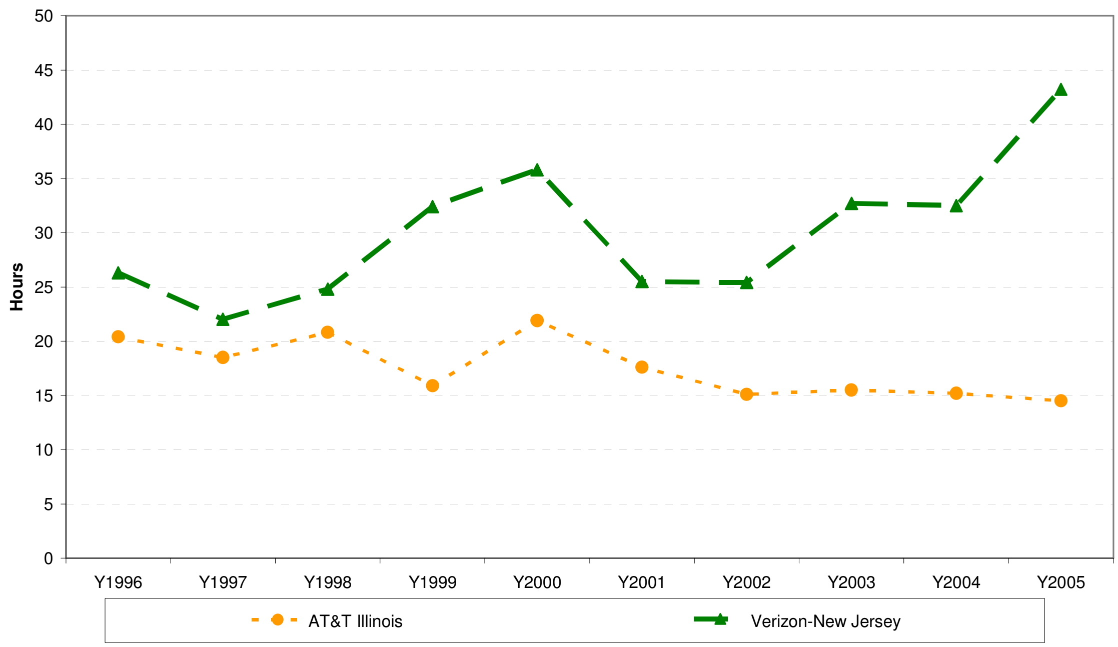
Sufficient competition in the basic local exchange market does not exist to yield adequate service quality. Furthermore, as Verizon diverts corporate attention and field personnel to its FiOS and cable business, service quality will likely deteriorate further.[166] Therefore, safeguards are essential to protect consumers from the improper subsidization of new services with resources that should be assigned to basic regulated ones.

[166] / As Chapter 1 indicates, Verizon's planned sale of its landline business in the three northern New England states provide further evidence of the vulnerability of non-FiOS customers to Verizon's corporate focus on new lines of business. In Maine, New Hampshire, and Vermont, FairPoint Communications Inc. (the company that intends to purchase Verizon's operations) considers itself a "rural, small-urban focused company" and considers northern New England customers its "bread and butter customers." "Verizon to sell lines in N.H., Vt., and Maine," Carolyn Y. Johnson, *Boston Globe*, C1, January 17, 2007, quoting Walt Leach, executive vice president of corporate development for Fairpoint. By contrast, in New Jersey, rural communities' needs will likely take the back seat to Verizon's FiOS focus. Furthermore, Verizon's efforts to obtain further deregulation of its noncompetitive services will exacerbate this issue further. *See, e.g.*, *In the Matter of the Board's Investigation Regarding the Reclassification of Competitive Local Exchange Carrier (CLEC) Services as Competitive,* New Jersey Board of Public Utilities Docket No. TX06120841, Joint Direct Testimony of William E. Taylor and Paul B. Vasington, on behalf of Verizon, January 9, 2007.

3.10.2. Financial accountability creates an incentive for adequate service quality, even where competitive pressures are lacking.

By way of comparison, as Figure 8 and Figure 9 show, based on the same two metrics, and over the same period of time, AT&T's service quality in Illinois exceeds that of Verizon's in New Jersey. The service quality gap has widened over time: Verizon New Jersey's response time to repair requests was both shorter and more in line with that in Illinois in the mid-to-late 1990s than it is today.

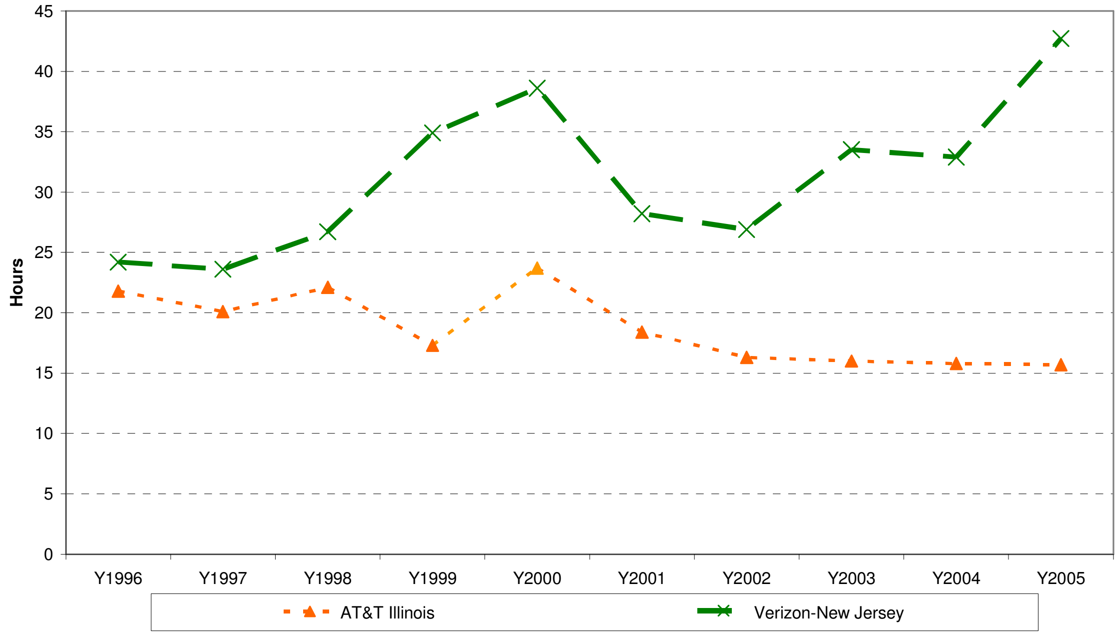
Figure 8
AT&T in Illinois Outperforms Verizon in New Jersey
(Initial Out-of-Service Interval: Residential Customers)



Source: FCC Report 43-05 ARMIS Service Quality Report, Table II. Installation and Repair Intervals (Local Service), Row 145, Accessed 1/12/2007.

Figure 9 shows a similar pattern of inferior service quality in New Jersey relative to Illinois, as measured by customers who have repeat problems on the same line. The evidence suggests that Verizon New Jersey is allocating insufficient resources (*e.g.*, field technicians) to provide service for its base of traditional telephone customers. As Verizon continues to pursue the cable business, its financial incentives will continue to jeopardize basic telephone service quality.

Figure 9
AT&T in Illinois Outperforms Verizon in New Jersey
(Repeat Out-of-Service Interval: Residential Customers)



Source: FCC Report 43-05 ARMIS Service Quality Report, Table II. Installation and Repair Intervals (Local Service), Row 149, Accessed 1/12/2007.

A long history of financial incentives for providing adequate service quality may explain the better service quality that Illinois households receive relative to their counterparts in New Jersey. An integral component of the original price cap plan that governed Ameritech - Illinois (now AT&T), approved by the Illinois Commerce Commission in 1994, was a service quality offset of as much as two percentage points a year to the "X" factor if the company failed to meet all of its service quality performance standards.[167] Several years later, as a result of state-enacted legislation, telecommunications carriers were directed to provide customer credits for (1) out-of-service over 24 hours; (2) installation occurring after five days; and (3) missed appointments.[168] By comparison, Verizon New Jersey has not had and continues to lack a compelling financial incentive to maintain and/or improve its service quality.

[167] / *Petition to Regulate Rates and Charges of Noncompetitive Services Under an Alternative Form of Regulation,* Illinois Commerce Commission Docket No. 92-0448/93-0239 Consol., rel. October 11, 1994, at 56-59.

[168] / 83 Ill.Adm. Code 732, effective August 1, 2001; Illinois Commerce Commission, Docket No. 98-0252, Illinois Bell Telephone Company Application for review of alternative regulation plan; Docket No. 98-0335, Illinois Bell Telephone Company petition to Rebalance Illinois Bell Telephone Company's Carrier Access and Network Access Line Rates; Docket No. 00-0764, Citizens Utility Board and the People of the State of Illinois -v- Illinois Bell Telephone Company, Verified Complaint for a Reduction in Illinois Bell Telephone Company's Rates and Other Relief, Order, December 30, 2002, at 196.

3.10.3. Verizon's experience in New York is instructive.

The conflict in New York between FiOS and plain old telephone service is instructive of the likely conflict brewing in New Jersey between new and old services. In New York, where Verizon has been rolling out FiOS, the Public Service Commission faulted Verizon for failing to provide adequate service and raised the possibility of penalties.[169] In a report submitted to the New York Public Service Commission, Staff noted deficiencies in seven of 35 service repair bureaus. Among other things, the Commission Chairwoman, Patricia L. Acampora, observed that "the Commission is obligated by law to ensure adequate service quality for those customers who rely on Verizon's copper network for their telephone service."[170] Similarly, the Board continues to have oversight of the adequacy of Verizon NJ's service quality, and, therefore, of the degree to which Verizon's pursuit of new services jeopardizes its ability to provide adequate phone service over copper lines. The New York Public Service Commission stated the following about Verizon's possible neglect of its copper network while it pursues the deployment of its FiOS network:

> We recognize Verizon needs to reconfigure its network in order to remain a viable service provider in the long term and its fiber strategy is an aggressive move in that direction. Nonetheless, the company also must concentrate adequate resources to satisfy all of its existing customers' service quality needs as determined by our Service Standards and meet its obligation under Public Service Law to provide adequate service. Public safety and network reliability remain paramount, in our view, regardless of the technology used to provide telecommunications services. We remain concerned about Verizon's ability to develop and implement service improvement plans to improve timeliness of repair performance given the deployment of a fiber network while most consumers continue to be served via the existing copper network. With minimal investment, the copper network is aging and, in all likelihood, could show signs of increasing trouble reports that may overwhelm the company's ability to repair out-of-service conditions in a timely manner statewide, rather than just a few selected locations that we will address shortly.[171]

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[169] / "PSC raps Verizon service in some areas," Mark Johnson, *The Boston Globe*, January 8, 2007, http://www.boston.com/business/articles/2007/01/08/psc_raps_verizon_service_in_some_areas/

[170] / New York Public Service Commission Press Release, "Verizon Service Quality Report," December 13, 2006. http://www3.dps.state.ny.us/pscweb/WebFileRoom.nsf/Web/BDE7EDAFD43A84AE8525724300640E80/$File/pr06074.pdf?OpenElement.

[171] / *Proceeding on Motion of the Commission to Consider the Adequacy of Verizon New York's Retail Service Quality Processes and* Programs, New York Public Service Commission Case 03-C-0971, *Order Directing Verizon New York Inc. to Demonstrate that Its Service Improvement Plans Are Sufficient*, December 19, 2006.

The Board's regulations should establish safeguards to create adequate incentives for Verizon to first improve and then to maintain its basic telephone service quality, and similarly for incumbent cable carriers to provide adequate service quality for basic cable products.

3.11. Consumers bear the cost of cross-subsidization.

Improper cross-subsidization harms consumers. When cross-subsidization occurs, companies charge high rates for regulated, noncompetitive services and divert resources toward new lines of business, jeopardizing the quality of basic services. Also, anticompetitive cross-subsidization thwarts emerging competition, which, in turn, denies consumers the benefit that a sufficiently competitive market would otherwise offer. Finally, improper cross-subsidization yields rates that are not aligned with costs: these inaccurate pricing signals lead to market distortions in the supply of and demand for telecommunications and cable services.

Absent regulatory intervention, incumbents will under-assign benefits and over-assign costs to their traditional lines of business, where they dominate markets. The foregoing discussion is not intended to be exhaustive, but rather to illustrate the compelling and invaluable assets that Verizon and incumbent cable operators enjoy by virtue of their historic dominance in New Jersey's markets. The next chapter discusses how existing policy fails to mitigate adequately harm to consumers.

4. EXISTING FEDERAL AND STATE POLICIES DO NOT PROTECT CONSUMERS ADEQUATELY

4.1. Introduction.

The previous chapters demonstrate that the telco and cable industries possess the incentive and the ability to subsidize unregulated services with noncompetitive ones, which, in turn, will distort the market and yield the economically inefficient supply and pricing of cable and telco services. Although federal and state legislation and policy prohibit cross-subsidization,[172] adequate accountability and incentives to encourage incumbents' compliance are sorely lacking. Relevant principles exist, but regulators lack the tools to deter anti-competitive abuses and to monitor firms' compliance. Indeed, as Chapters 2 and 3 demonstrate, Verizon possesses the ability and the incentive to leverage its market power (derived from its dominance of local, long-distance, and bundled services markets) to subsidize its foray into cable services. Similarly, cable companies possess the ability and incentive to leverage their monopoly position in the cable market to subsidize their pursuit of telephone services. This chapter summarizes some of the major existing policies and regulations that affect potential cross-subsidization, and also discusses some regulatory decisions that may provide useful models for designing appropriate safeguards in New Jersey today.

4.2. Federal Statutory Policy: The Telecommunications Act of 1996.

4.2.1. The goal of Section 254(k) is relevant, but, unless and until the Commission corrects carriers' assignment and allocation of common plant, cannot be achieved.

More than ten years ago, in its passage of the sweeping Telecommunications Act of 1996, Congress explicitly prohibited subsidization of competitive services by noncompetitive services. Section 254(k) of the 1996 Act states:

> A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition. The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.[173]

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[172] / 1996 Act, Section 254 (k); *N.J.S.A.*:48:2-21-18.c.

[173] / 1996 Act, Section 254 (k).

Despite this unambiguous statutory mandate, the FCC and state regulators have not yet established and enforced the necessary cost allocation rules and cost accounting safeguards to "ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."

The FCC's pending investigation of "separations" in Docket No. 80-286,[174] bears directly on its ability to prevent and to detect improper cross-subsidization, particularly as carriers use extensive common network and resources as an invaluable strategic and physical platform from which to enter unregulated lines of business, such as digital subscriber line service, bundled offerings, and FiOS-based Internet and video services.[175] Although the FCC's Part 64 rules address cross-subsidization in principle, they fail to protect consumers adequately in their implementation.[176]

The jurisdictional separations process determines the manner in which ILECs apportion regulated costs among jurisdictions (*i.e.,* interstate and intrastate jurisdictions). The FCC has stated: "one of the primary purposes of the separations process has been to prevent incumbent LECs from recovering the same costs in both the interstate and intrastate jurisdictions."[177] In conducting the jurisdictional separations process, carriers first assign the regulated cost of categories of plant and expenses (and sometimes among services with those categories). Carriers then allocate the costs in each category to the intrastate or interstate jurisdiction based upon: a relative use factor, a fixed allocator, or, by direct assignment (when allowed by Part 36 rules[178]).[179]

In discussing why competition and the advent of new technologies suggest a need for changes in the separations process, the FCC explained:

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[174] / *FCC Separations FNPRM*. As noted above, the Rate Counsel is participating in this proceeding. *See*, Comments of the National Association of State Utility Consumer Advocates, the New Jersey Division of Rate Counsel and the Maine Office of the Public Advocate in CC Docket No. 80-286, August 22, 2006; Reply Comments of the National Association of State Utility Consumer Advocates, the New Jersey Division of Rate Counsel and the Maine Office of the Public Advocate in CC Docket No. 80-286, November 20, 2006; Affidavit of Susan M. Baldwin on behalf of the New Jersey Division of Rate Counsel and the National Association of State Utility Consumer Advocates in CC Docket No. 80-286, August 22, 2006.

[175]/ As discussed earlier, the FCC declared DSL to be an information service and also determined that Verizon and other Bells do not need to offer unbundled fiber to competitors. *Wireline Broadband Order.*

[176] / Furthermore, as this chapter explains below, although the Board has the authority to establish and enforce cost accounting requirements, state accounting rules are inadequate.

[177]/ *FCC Separations FNPRM*, at para. 2.

[178]/ *FCC Separations FNPRM,* at para. 4.

[179]/ 47 C.F.R. Part 69.

> Jurisdictional cost shifts in separations results generally are caused by changes in any of three areas: overall cost levels, categorization of costs (*i.e.*, relative category assignments), or jurisdictional allocation factors. A carrier's increased overall cost level in a Part 32 account that has a high cost allocation to the interstate jurisdiction will cause shifts to the interstate jurisdiction for other investment and expense accounts whose jurisdictional allocations are dependent on that account. Increasing investment in specific categories (*e.g.*, interexchange cable and wire facilities (C&WF)) may also contribute to jurisdictional shifts in the final results. Likewise, changes in customer calling patterns (*e.g.*, increased interstate calling) will cause shifts in the jurisdictional allocation factors, many of which are based on usage. These factors allocate a significant portion of a carrier's investment between the interstate and intrastate jurisdictions.[180]

Cost accounting rules have not kept pace with the emergence of new technology and regulatory changes. Many major factors have created a substantial mismatch between intrastate regulated revenues, which exclude services such as DSL, , and intrastate regulated costs, which are based on the fixed intrastate/interstate allocation factor of 75%/25% for the local loop (the feeder and distribution networks and associated expenses), and frozen usage factors. Among the changes that render these frozen factors grossly incorrect are the deployment of new technologies such as DSL and fiber to the home and curb; jurisdictional changes such as the treatment of broadband,[181] VoIP,[182] and

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180/ *FCC Separations FNPRM*, at footnote 23.

181 / The Commission determined that DSL service is interstate in 1998. *GTE DSL Order*, 13 FCC Rcd at 22474-83. The Commission subsequently determined that wireline broadband Internet service is an information service. *Wireline Broadband Order*.

182 / In 2004, the Commission adopted the *Vonage Order* in which it declared that it had jurisdiction over VoIP services. *Vonage Holdings Corporation for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission*, WC Docket No. 03-211, *Memorandum Opinion and Order*, 19 FCC Rcd 22404 (2004) ("Vonage Order"). The Commission released an order in the summer of 2005 requiring interconnected VoIP providers to provide enhanced 911 by November 28, 2005. *In the Matters of IP-Enabled Services; E911 Requirements for IP-Enabled Service Providers*, FCC WC Docket Nos. 04-36; 05-196, *First Report and Order and Notice of Proposed Rulemaking*, Adopted May 19, 2005, Rel. June 3, 2005 ("VoIP E911 Order"). Most recently, the Commission determined that interconnected VoIP providers should contribute to the USF. *In the Matter of Universal Service Contribution Methodology,* WC Docket No. 06-122*; Federal-State Joint Board on Universal Service,* CC Docket No. 96-45*; 1998 Biennial Regulatory Review – Streamlined Contributor Reporting Requirements Associated with Administration of Telecommunications Relay Service, North American Numbering Plan, Local Number Portability, and Universal Service Support Mechanisms*; CC Docket No. 98-171; *Telecommunications Services for Individuals with Hearing and Speech Disabilities, and the Americans with Disabilities Act of 1990*, CC Docket No. .90-571; *Administration of the North American Numbering Plan and North American Numbering Plan Cost Recovery Contribution Factor and Fund Size*, CC Docket No. 92-237, NSD File No. L-00-72; *Number Resource Optimization*, CC Docket No. 99-200; *Telephone Number Portability*, CC Docket No. 95-116; *Truth-in-Billing and Billing Format*, CC Docket No. 98-170; *IP-Enabled Services*, WC Docket No. 04-36, *Report and Order and Notice of Proposed Rulemaking*, Rel. June 27, 2006 ("USF Contribution Order").

calls to Internet service providers;[183] and Bells' Section 271 authority to offer long distance service.

The Federal-State Joint Board on Jurisdictional Separations remarked in a recent report that "Section 254(k) of the 1996 Act establishes a *duty* for the FCC and the states" to ensure that universal service "bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."[184] The statutory prohibition set forth by Congress in the 1996 Act does not, in isolation, provide sufficient protection for consumers and competitors.

4.2.2. Although the Section 272 requirement for the separation of Bell operating companies' long distance operations has sunset throughout the country, it provides a useful model of safeguards.

4.2.2.1. Introduction

Among other things, the 1996 Act also set forth the requirement that Bell operating companies operate their in-region, long-distance business through separate affiliates, subject to specific requirements for a minimum of three years.[185] The purpose of the requirement for separate long-distance entities was to prevent anti-competitive cross-subsidization and to ensure that Bells did not discriminate in favor of their new long distance operations and against other long distance providers.

Section 272(a)(1) of the 1996 Act required a BOC to operate its in-region long distance business through one or more affiliates that are separate from any operating company entity that is subject to the requirements of section 251(c); and that meet the requirements of subsection (b) of Section 272. Section 272(b) establishes the relationship between the BOC and its in-region interLATA affiliate, and requires the separate affiliate to operate independently from the BOC. The affiliate must maintain its own separate

[183] / The Commission has determined that communications to Internet service providers ("ISP") is an interstate service. *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, *Intercarrier Compensation for ISP-Bound Traffic*, CC Docket No. 99-68*, Order on Remand and Report and Order*, FCC 01-131 (released April 27, 2001).

[184] / "Post-Freeze Options for Separations," State Members of the Separations Joint Board, October 25, 2005, included as Appendix B to the Separations ("Glide Path II Paper"), at 8, emphasis added.

[185] / These requirements sunset in all BOC territories during the period December 2002 (Verizon New York) through December 2006 (Qwest Arizona). *See*, http://www.fcc.gov/Bureaus/Common_Carrier/in-region_applications. In June, 2005, these requirements sunset for Verizon's operations in New Jersey. Federal Communications Commission, Public Notice, "Section 272 Sunsets for Verizon Communications, Inc. by the Operation of Law on June 24, 2005 Pursuant to Section 272(f)(1)," WC Docket No. 02-112, DA 05-1784. The Act's Section 272(f), provides, among other things, for the sunset of the separate affiliate requirement in section 272(a). With respect to interLATA telecommunications services in particular, 272(f) provides for sunset three years after grant of section 271(d)(3) approval, unless the Commission extends the three-year period by rule or order. For interLATA information services, the sunset period was four years after enactment of the 1996 Act (unless extended by rule or order).

books, records, and accounts; have separate officers, directors, and employees; and not obtain credit in a manner that would provide the creditor with recourse to the BOC. Section 272(b)(5) requires that the in-region interLATA affiliate conduct all transactions with the Bell operating company of which it is an affiliate on an arm's length basis with any such transactions reduced to writing and available for public inspection.

The Commission interpreted Section 272(f) to provide for a state-by-state sunset of the separate affiliate requirements,[186] and allowed the first sunset to occur with respect to Verizon New York as a matter of law. In a dissenting opinion attached to a Memorandum Opinion and Order determining state-by-state sunset, Commissioners Adelstein and Copps noted that although the Commission could have extended the separate affiliate requirements, instead the Commission allowed the 272 sunset without "necessary analysis." These two Commissioners stated further: "Congress clearly gave the Commission the charge to determine whether these structural, accounting, and auditing safeguards remain necessary to prevent anticompetitive discrimination in the market. Yet the Commission has neglected to consider whether there is a need for these or alternative safeguards."[187]

Several developments provide compelling evidence that alternative safeguards are long overdue:

- The growth in Verizon's bundles.
- Verizon's acquisition of MCI.
- Verizon's entry into the cable business.

The measures that originally governed Verizon's long-distance entry (before they sunset) included non-accounting and accounting safeguards.[188] In the orders establishing these safeguards, the FCC addressed such issues as accounting, affiliate transactions, non-discrimination, joint marketing, and enforcement, which are germane to the Board's design of cable rules that are compatible with fair and effective competition in New Jersey.

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[186] / *In the Matter of Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, FCC WC Docket No. 02-112, *Memorandum Opinion and Order*, rel. December 23, 2002, at para. 2.

[187] / Joint Statement of Commissioner Jonathan S. Adelstein and Commissioner Michael J. Copps, Dissenting in Part, Re: Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements, FCC 02-336, December 23, 2002. Similarly, Commissioner Martin issued a concurring statement questioning the Commission's decision to allow the section 272 requirements to sunset and the fact that the decision was announced through a public notice rather "than a Commission order responding to questions raise on the record." Concurring Statement of Commissioner Kevin J. Martin, Re: Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements, FCC 02-336, December 23, 2002.

[188] / The FCC addressed non-accounting safeguards in CC Docket No. 96-149 and accounting safeguards in CC Docket No. 96-150.

4.2.2.2. Accounting Safeguards.

In its initial order in the "Accounting Safeguards" proceeding,[189] the FCC stated, among other things:

> This Order prescribes the way incumbent local exchange carriers, including the Bell Operating Companies ("BOCs"), must account for transactions with affiliates involving, and allocate costs incurred in the provision of, both regulated telecommunications services and nonregulated services, including telemessaging, interLATA telecommunications, information, manufacturing, electronic publishing, alarm monitoring and payphone services, to ensure compliance with the Act. In particular, the Order adopts the tentative conclusion in the Notice of Proposed Rulemaking ("NPRM") in this proceeding that our current cost allocation rules generally satisfy the Act's accounting safeguards requirements when incumbent local exchange carriers, including the BOCs, provide services permitted under sections 260 and 271 through 276 on an integrated basis (i.e., within the telephone operating companies). The Order also adopts the tentative conclusion in the NPRM that our current affiliate transactions rules generally satisfy the Act's accounting safeguards requirements when incumbent local exchange carriers, including the BOCs, are required to, or choose to, use an affiliate to provide services permitted under sections 260 and 271 through 276. The Order adopts most of the NPRM's proposed modifications to the affiliate transactions rules to provide greater protection against subsidization of competitive activities by subscribers to regulated telecommunications services.[190]
>
> …
>
> In our NPRM, we set forth two goals for this proceeding: (1) preserving for the benefit of interstate telephone ratepayers legitimate economies of scope that could be realized by BOCs and other incumbent local exchange carriers when entering markets from which they were previously barred or in which they continue to participate; and (2) discouraging, and facilitating detection of, improper cost allocations in order to prevent incumbent local exchange carriers from imposing the costs of their competitive ventures on interstate telephone ratepayers. In the NPRM, we asked the threshold question: to what, if any, extent should we rely on our existing accounting safeguards in Parts 32 and 64 of our rules to achieve these two goals. We

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189 / In the Matter of the Implementation of the Telecommunication Act of 1996, Accounting Safeguards under the Telecommunications Act of 1996, FCC CC Docket No. 96-150, Report and Order, rel. December 24, 1996 ("Accounting Safeguards Order").

190 / *Id.*, at para. 1.

> tentatively concluded that our existing accounting safeguards, with the modifications described in the NPRM, would best meet the requirements and underlying goals of sections 260 and 271 through 276. We invited comment on this tentative conclusion. We also sought comment on whether less detailed accounting safeguards would suffice to achieve the objectives of the Act.[191]

As the excerpt indicates, the FCC determined that its existing system of accounting safeguards found in Parts 32 and 64 of its rules satisfied the 1996 Act's accounting safeguard requirements *when a Bell used an affiliate to provide services*. The cost accounting safeguards consist of rules concerning affiliate transactions[192] and cost allocation.[193] Appendix 3 includes relevant excerpts from Parts 32 and 64 of the FCC's cost accounting rules.

These cost accounting rules, alone, will not protect consumers from bearing the cost and risk of Verizon's entry into new lines of business in New Jersey for, among others, the following reasons:

- The FCC's rules govern *interstate services.* Therefore, at a minimum, corresponding intrastaste cost accounting rules are necessary to protect intrastate ratepayers.[194]

- As a threshold matter, the Board's examination of Verizon's separation of costs between the intrastate and interstate jurisdiction is long overdue: Absent such an investigation, one cannot ascertain whether Verizon is assigning and allocating sufficient costs to the various services that have been deemed interstate or unregulated.[195]

- Without provisions for accountability and enforcement, rules are meaningless. Periodic audits conducted by a third party of Verizon's books and cost allocation methodology, subject to review by the Board and Rate Counsel, are essential.

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191 / *Id.*, at para. 13.

192 / 47 C. F. R. § 32.27.

193 / 47 C. F. R. §§ 64.901-904.

194 / Ten years ago, the FCC concluded that "[n]either the information contained in the record nor our experience provides us with any basis to conclude that existing state accounting systems that differ from our federal system will result in the type of subsidization of competitive activities prohibited by sections 260, 271, 272 and 274 through 276." *Accounting Safeguards Order*, at para. 44. However, as discussed later in this chapter, adequate accounting systems do not exist in New Jersey.

195 / As Table 2 shows, DSL services in New Jersey represent a substantial and growing revenue source for New Jersey, yet the Board has not yet ascertained whether Verizon New Jersey's intrastate regulated operations are subsidizing improperly this line of business.

- Carriers need to put in writing the way in which they compensate the telco operations and retain these records so that these transactions can be reviewed.

4.2.2.3. Non-Accounting Safeguards.

In its initial *Non-Accounting Safeguards Order,*[196] which governed Bells' entry into long-distance markets, the FCC addressed issues such as non-discrimination,[197] joint marketing,[198] and enforcement.[199] In interpreting the 1996 Act's mandate that the Bells operate their long distance operations affiliate independently, the FCC prohibited the joint ownership of transmission and switching facilities and the property on which they are located, but did not prohibit all joint ownership of property.[200] The FCC also determined that although a Bell and its section 272 affiliate were required to have separate officers, directors and employees (that is personnel could not be on the payrolls of the Bell and its affiliate), sharing of in-house personnel was allowed, provided that the transaction complied with the provisions of section 272(b)(5) regarding affiliate transactions.[201] The FCC determined that the Bell and its affiliate could provide marketing services for each other, provided that they were provided pursuant to an arm's length transaction.[202] The FCC also determined that section 272(b)(4) of the 1996 Act prohibited a Bell from co-signing a contract or other financial instrument with a section 272 affiliate "that would allow the affiliate to obtain credit in a manner that grants the creditor recourse to the BOC's assets in the event of default by the section 272 affiliate."[203]

Among other things, the FCC reasoned as follows:

> These safeguards are intended both to protect subscribers to BOC monopoly services, such as local telephony, against the potential risk of having to pay costs incurred by the BOCs to enter competitive markets, such as interLATA services and equipment manufacturing, and to protect competition in those markets from the BOCs' ability to use their existing

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196 / *First Report and Order and Further Notice of Proposed Rulemaking*, CC Docket No. 96-149, released December 24, 1996 ("Non-Accounting Safeguards Order"). These provisions generally prescribe the manner in which the BOCs may enter certain new markets, including the in-region interLATA services market and the prohibitions on the integration of the affiliate's interLATA network with the BOC. In its Second Order on Reconsideration, the Commission addressed section 272(e)(4) in greater depth (rel. June 24, 1997).

197 / *Id.*, at paras. 198-236.

198 / *Id.,* at paras. 272-297.

199 / *Id.*, at paras. 318-352.

200 / *Id.*, at paras. 159-162.

201 / *Id.*, at paras. 178-181.

202 / *Id.*, at para. 183.

203 / *Id.*, at para. 189.

> market power in local exchange services to obtain an anticompetitive advantage in those new markets the BOCs seek to enter.[204]

Ten years later, Verizon continues to possess market power and continues to enter new markets beyond the scope of its intrastate regulated operations. Therefore, the FCC's reasoning applies to New Jersey's market today, and many of the safeguards that the FCC established to govern Bells' entry into long distance markets provide useful models to guide the Board's establishment of safeguards as cable and telecommunications companies enter each other's lines of business.

4.2.2.4. LEC Classification Order.

In the *LEC Classification Order*,[205] the FCC determined that dominant carrier regulation would be imposed on BOC interLATA affiliates only if they could unilaterally raise and sustain prices above competitive levels and thereby exercise market power. Dominant carriers, in contrast to non-dominant carriers, would be subject to price-cap regulation and follow tariff notice and filing requirements. The Commission states:

> In light of the requirements established by, and pursuant to, sections 271 and 272, together with other existing Commission rules, we conclude that the BOCs will not be able to use, or leverage, their market power in the local exchange or exchange access markets to such an extent that their section 272 interLATA affiliates could profitably raise and sustain prices of in-region, interstate, domestic, interLATA services significantly above competitive levels by restricting the affiliate's own output. We also conclude that regulating BOC in-region interLATA affiliates as dominant carriers generally would not help to prevent improper allocations of costs, discrimination by the BOCs against rivals of their interLATA affiliates, or price squeezes by the BOCs or the BOC interLATA affiliates. Although certain aspects of dominant carrier regulation may address these concerns, we conclude that the burdens they would impose on competition, competitors, and the Commission outweigh any potential benefits. As a result, we classify the BOC interLATA affiliates as non-dominant in the provision of in-region, interstate, domestic, interLATA services.[206]

However, telecommunications markets have become vastly more concentrated since the FCC issued this decision. SBC's acquisition of AT&T and Verizon's acquisition of MCI have altered the market structure substantially since the FCC issued

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[204] / *Id.*, at para. 6.

[205] / *Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interexchange Marketplace*, CC Docket Nos. 96-149, 96-61, Second Report and Order in CC Docket No. 96-149 and Third Report and Order in CC Docket No. 96-61, 12 FCC Rcd15756 (1997) ("LEC Classification Order").

[206] / *Id.*, at para. 6.

its orders. As Appendix 2 shows, Verizon has rapidly re-monopolized bundled and long distance markets.

4.2.3. The 1996 Act also directed the Commission to establish nonstructural safeguards for Bells' payphone services.

The 1996 Act also requires nonstructural safeguards for Bells' payphone services. Specifically, Section 276(b)(1)(C) of the 1996 Act directs Commission to "prescribe a set of nonstructural safeguards for Bell operating company payphone service to implement the provision of paragraphs (1) and (2) of subsection (a), which safeguards shall, at a minimum, include the nonstructural safeguards equal to those adopted in the Computer Inquiry – III (CC Docket No. 90-623) proceeding."[207] Section 276(a) states that a BOC "(1) shall not subsidize its payphone service directly or indirectly from its telephone exchange service operations or its exchange access operations; and (2) shall not prefer or discriminate in favor of its payphone service."[208] The FCC issued its "Payphone Order" in September 1996, in which it set forth requirements for Bells' pay telephone operations.[209] In response to these requirements, in January 1997, Verizon (at the time, the Bell Atlantic Telephone Companies), filed a comparably efficient interconnection ("CEI") plan for basic payphone service with the FCC in which Verizon described how it would make its regulated basic services available on a nondiscriminatory basis to independent payphone service providers and to its own payphone operations.[210]

The 1996 Act required, among other things, that the safeguards, at a minimum, had to include the nonstructural safeguards that the Commission adopted in its *Computer III* proceeding.[211] As explained by the FCC, under the *Computer III* framework, Bells were required to describe in their Comparably Efficient Interconnection ("CEI") plans:

(1) the enhanced service or services to be offered;

(2) how the underlying basic services would be made available for use by competing ESPs [enhanced service providers]; and

[207] / 47 U.S.C. § 276 (b)(1)(C).

[208] / 47 U.S.C. § 276 (a).

[209] / *Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-128, *Report and Order*, FCC 96-338, released September 20, 1996 ("Payphone Order").

[210] / *In the Matter of Bell Atlantic Telephone Companies' Comparably Efficient Interconnection Plan for the Provision of Basic Payphone Services, Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-128, *Order*, April 15, 1997.

[211] / 47 U.S.C. § 276(b)(1)(C).

(3) how the BOCs would comply with the other nonstructural safeguards imposed by *Computer III*.[212]

Among other things, Verizon demonstrated its compliance with the *Computer III* requirement that its enhanced services offering take the basic services at their unbundled tariff rates "as a means of preventing improper cost-shifting to regulated operations and anticompetitive pricing in unregulated markets."[213]

In the context of the cable regulations presently under review by the Board, similar protections are relevant to ensure that when Verizon and the cable industry offer triple and quadruple plays,[214] they compensate their basic operations properly. By way of illustration, when Verizon offers a "Freedom" package, which includes, for example, long distance, DSL, unlimited local calling, directory assistance, and custom calling features, Verizon should compensate its intrastate noncompetitive operations at tariffed rates for the unlimited local calling, directory assistance, and custom calling features that the bundle encompasses. When Verizon offers a bundle with FiOS-based cable, similarly, it should compensate its intrastate regulated operations based on the tariffed rates for any relevant portions of the bundle *and* should assign and allocate a fair share of any joint and common costs (such as marketing, overhead, shared network plant, etc.).

4.2.4. The FCC has a long history of establishing safeguards against cross-subsidization, which can inform the Board's design of effective cable franchising regulations.

In addition to its proceeding governing the Bells' entry into new lines of business, and its proceeding examining the adequacy of its cost allocation and separations rules in Docket 80-286, which are discussed above, the FCC has analyzed and addressed cross-subsidization in other proceedings. This paper does not attempt to replicate the nuances of each and every such FCC docket, but rather highlights some of the findings and policy that are particularly germane to today's market in New Jersey. Although measures that protect customers against bearing improperly the cost and risk of carriers' entry into new lines of business may seem archaic in today's rapidly evolving information age, today's marketplace – although in flux – is not sufficiently competitive. Therefore, despite the hoopla about competition, customers of basic telecommunications and basic cable services (whom neither the cable nor telco markets seek to attract and retain), competitors, and potential new entrants are vulnerable to the harmful effects of improper cross-subsidization.

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212 / *Payphone Order*, at fn 36, citing *Amendment of Section 64.702 of the Commission's Rules and Regulations,* CC Docket No. 85-229, Phase I ("Phase I Order"), 104 FCC 2d at 1034-59, paras. 142-200.

213 / *Payphone Order*, at para. 20, citing *Phase I Order*, at para. 159.

214 / Triple play refers to a bundle including voice, data, and video. Quadruple play includes voice, data, video, and wireless.

4.2.5. Competitive Orders.

The FCC's *Competitive Carrier Fifth Report and Order,*[215] issued in 1984, included limited structural safeguards requirements. Between 1979 and 1985, the Commission conducted the *Competitive Carrier* proceeding, in which it examined how its regulations should be reformed to address competition in telecommunications markets. In a series of orders, the Commission distinguished between carriers with market power (dominant carriers) and those without market power (non-dominant carriers). Over time, the Commission relaxed its regulation of non-dominant carriers because it concluded that non-dominant carriers could not engage in conduct that may be anticompetitive or inconsistent with the public interest.

In its *Competitive Carrier First Report and Order*, the Commission classified local exchange carriers and legacy AT&T as dominant carriers and concluded that these dominant carriers should be subject to all of the then-existing Title II regulations. The Commission reclassified legacy AT&T as a non-dominant carrier in the interexchange market after determining that legacy AT&T no longer possessed the ability to unilaterally control prices in the interstate, domestic, interexchange telecommunications market.

In its *Fourth Report and Order*, the Commission considered how it should regulate the provision of interstate, interexchange services by independent LECs. The Commission determined that interexchange carriers affiliated with independent LECs would be regulated as non-dominant carriers. In the *Competitive Carrier Fifth Report and Order*, the Commission clarified that an "affiliate" of an independent LEC for purposes of qualifying for regulation as a non-dominant carrier is "a carrier that is owned (in whole or part) or controlled by, or under common ownership (in whole or part) or control with, an exchange telephone company."[216] The Commission determined that in order to qualify as a non-dominant carrier, the interexchange carrier affiliated with an independent LEC was required to:

> (1) maintain separate books of account;
>
> (2) not jointly own transmission or switching facilities with the exchange telephone company; and
>
> (3) obtain any exchange telephone company services at tariffed rates and conditions.[217]

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[215] / *Policy and Rules Concerning rates for Competitive Carrier Services and Facilities Authorizations Therefore,* FCC CC Docket No. 79-252*, Fifth Report and Order*, 98 FCC 2d 1191(1984)("Competitive Carrier Fifth Report and Order").

[216] / *In the Matter of Bell Operating Company Provision of Out-of-Region Interstate, Interexchange Services*, FCC CC Docket No. 96-21, *Notice of Proposed Rulemaking*, rel. February 14, 1996, at para. 4, citing *Competitive Carrier Fifth Report and Order*.

[217] / *Competitive Carrier Fifth Report and Order*, at para. 9.

The Commission further concluded that, if an independent LEC provided interstate, interexchange services directly, rather than through an affiliate, those services would be subject to dominant carrier regulation.

4.2.6. Relevance of FCC orders to the Board's rulemaking proceeding.

The previous discussion of various regulatory decisions in which the FCC implemented specific safeguards and enforcement provisions to ensure that the telecommunications industry could evolve in a competitively neutral way is intended to highlight possible elements of a system of safeguards for New Jersey. The particular system of safeguards the Board establishes can draw upon the rationale and measures of these prior regulatory decisions and then be tailored to the specific goals of New Jersey to encourage the development of an advanced information infrastructure without improper cross-subsidization.

4.3. New Jersey statute prohibits improper cross-subsidization.

In a statutory mandate that parallels the directive that the federal 1996 Act establishes, a New Jersey statute, enacted in 1992, prohibits the subsidization of competitive services with revenues derived from noncompetitive services. The Legislature stated that "[n]o local exchange telecommunications company may use revenues earned or expenses incurred in conjunction with noncompetitive services to subsidize competitive services."[218] However, as is the case with the federal statute, absent regulatory tools to monitor and audit carriers' accounting, the statutory prohibition, by itself, provides insufficient consumer protection. The following section discusses some of the Board's findings on this issue, and demonstrates that further Board guidance is essential to facilitate the competitively neutral evolution of an advanced information infrastructure in New Jersey that does not rely on consumers of basic telco and cable services to subsidize the industries' entry into new lines of business.

4.4. Board of Public Utilities policy.

4.4.1. *PAR-1 Order/PAR-2 Order.*

In its Order approving a plan of alternative regulation ("*PAR-I Order*"), which revised the form of regulation governing Verizon's intrastate telecommunications operations, the Board chose not to impose structural separations upon Verizon, but rather to to rely on embedded analysis system ("EAS") reporting.[219] The Board determined that

[218] / *N.J.S.A.*:48:2-21-18.c.

[219] / *In the Matter of the Application of New Jersey Bell Telephone Company for Approval of Its Plan for an Alternative Form of Regulation*, Docket No. T092030358, May 6, 1993 ("PAR-1 Order"). The Board addresses cross-subsidization and structural safeguards beginning at page 98 of the *PAR-1 Order*, see especially pages 99 – 115.

the EAS reports provided "an appropriate non-structural safeguard to ensure that the costs of NJ Bell are properly allocated and to ensure that cross-subsidization does not occur."[220] The Board further reasoned that EAS "is a cost allocation system now used by the Board to monitor NJ Bell's earnings for surveillance purposes under the Rate Stability Plan," and that the EAS "identifies and allocates all of the Company's costs, including all overhead costs, among all of the Company's services including not only directly assigned costs, but appropriate indirect costs as well."[221] The Board determined that it was not necessary to order structural safeguards.[222] During the Board's *PAR-1* investigation, it was observed that:

> The embedded analysis system is excessively and unnecessarily obtuse. NJB should not be permitted to embark on a new form of regulation unless and until it has responded to Staff's request for the design of a reasonable substitute for the quarterly report it now submits. Each and every allocator should be able to be understood by the Board and deemed appropriate.[223]

The need for clear accounting of carriers' assignment and allocation of costs is as relevant today as it was fifteen years ago.

The Board, in its *PAR-1 Order* also acknowledged that local telephone companies' provision of video programming could cause the FCC to impose structural safeguards at a later time.[224] Also, the Board stated, among other things, that it "reserves the right to consider, and impose to the extent permitted by law, other safeguards, such as fully separated subsidiaries, if this subsequently appears necessary."[225] Now that telecommunications and cable companies are entering each others' respective markets, fully separated subsidiaries should once again be considered by the Board.

In its *PAR-2 Order*, which further modified the regulatory framework governing Verizon's operations in New Jersey, the Board discontinued the EAS reporting requirement, stating:

> In addition, we FIND that PAR-2 provides for the simplification of monitoring and reporting on potential cross-subsidization of competitive services from non-competitive services. The Board DIRECTS VNJ to (1)

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220 / *Id.*, at 106. *See also, id.*, at 108.

221 / *Id.*

222 / *Id.*, at 109.

223 / *In the Matter of the Application of the New Jersey Bell Telephone Company for Approval of its Plan for an Alternative Form of Regulation*, New Jersey BPU Docket No. T092030358, Direct Testimony of Susan M. Baldwin, on behalf of the New Jersey Cable Television Association, filed September 21, 1992, at 32-33.

224 / *PAR-1 Order,* at 111-112.

225 / *Id.,* at 112.

> provide annual financial reports to the Board so that it may monitor the revenue and costs of its competitive services, and determine whether, in the aggregate, the total revenues for VNJ's competitive services exceed the total direct costs of those services, and (2) eliminate reports from the EAS system, and to provide annual financial reporting of its rate regulated services and to work together with Staff and the Advocate to determine the format for such annual financial reporting on its rate regulated services, and to ensure, as much as reasonably possible, that the format is consistent with similar reporting in other Verizon jurisdictions.[226]

In its earlier *PAR-1 Order,* the Board relied on EAS reports rather than structural separations to prevent improper cross-subsidization. However, as the above excerpt indicates, the *PAR-2 Order* eliminated the reasoning for the Board's original rejection in its *PAR-1* decision on structural separations (namely quarterly EAS reports). Therefore, the logic upon which the Board relied in its *PAR-1* decision to reject structural separations (namely the existence of EAS reports) evaporated with the *PAR-2 Order*. As a result, the Board should now revisit the merits of structural separations. Now, as new lines of business consume an increasing share of Verizon's corporate attention and priority,[227] conditions have changed sufficiently to merit the Board's close attention to these issues again. Furthermore, when the Board issued the *PAR-2 Order* four years ago, the focus of the concern was telecommunications services. Under the Cable Act,[228] Verizon's video programming service is a cable service, and therefore is not addressed by the *PAR-2* analysis.

Moreover, although the Board directed Verizon to work with Staff and the RatepayerAdvocate to determine the format for the annual reports, no such effort has been undertaken, nor has the intended monitoring occurred. Without these reports or similar ones, the Board and Rate Counsel lack the rudimentary information necessary to detect any improper cross-subsidization. Verizon NJ should submit detailed financial and cost accounting reports that enable the Board to understand and to assess the way in which Verizon NJ assigns and allocates costs among its various lines of business. Furthermore, the methods and magnitude of cost assignment and allocation should be clear.

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[226] / *In the Matter of the Application of Verizon New Jersey Inc. For Approval (I) of a New Plan for an Alternative Form of Regulation and (ii) to Reclassify Multi-Line Rate Regulated Business Services as Competitive Services, and Compliance Filing*, New Jersey Board of Public Utilities Docket No. TO01020095, *Decision and Order*, August 19, 2003 ("PAR-2 Order"), at 54.

[227] / Sections 3.9.1 through 3.9.3 demonstrate that Verizon is neglecting basic telecommunications services as it deploys FiOS deployment and in its race to offer cable. The re-assignment of field technicians to support FiOS deployment is an example of a form of improper cross-subsidization.

[228] / P.L.1972, c.186 (C.48:5A-1 *et seq.*), as amended and supplemented ("Cable Television Act" or "Cable Act").

Based on technological and regulatory developments that the Board could not have anticipated fully when it issued its *PAR-2 Order*, the time is ripe for the Board to re-assess its regulatory tools for preventing and detecting improper cross-subsidization.

4.4.2. The Board's reasoning and analysis in its investigation of energy utilities applies equally to the telco-cable industries.

The Board's reasoning underlying the rules adopted in October 2006 for energy competition and public utility holding companies is germane to the Board's development of cable regulations. The Board has a comprehensive regulatory scheme in place to regulate New Jersey utilities and the relationships of the utilities with their affiliates to the extent those relationships might interfere with the utilities' provision of safe, adequate and proper service to their customers at reasonable rates. This authority is broad and includes authority over rates, service quality, affiliate transactions, the transfer of control over a public utility as well as a variety of other areas.

Additionally, the Board has many other avenues for protecting utilities from any risk of affiliate diversification, through the control of regulatory capital structure, rates of return, the sale or encumbrance of utility assets, contracts with affiliates, and its general authority over customer rates. If necessary, the Board can require any New Jersey utility that is not already so structured to operate as a separate legal entity from its parent or affiliates, as most (if not all) New Jersey utilities already do and can impose other "ring fencing" protections.

The Board confirmed its authority when it concluded: "It is well established that the Board 'may exercise jurisdiction not only over the bottom corporate tier of the chain, the actual New Jersey [public utility], but to any entity which owns, controls, manages or operates that entity.'"[229] The Board further stated that:

> This sweeping grant of power is "intended to delegate the widest range of regulatory power over utilities to the [BPU]" . . . The BPU's authority over utilities, like that of regulatory agencies generally, extends beyond powers expressly granted by statute to include incidental powers that the agency needs to fulfill its statutory mandate.[230]

The Board also correctly identified the risks that are involved when public utilities diversify and invest in non-utility businesses. The Board explains:

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[229] / 38 N.J.R. 4237(a), Volume 38, Issue 19, New Rules: *N.J.A.C.* 14:4-4A, issued October 2, 2006, Energy Competition Standards, Public Utility Holding Company Standards ("Energy Competition and Public Utility Holding Standards"), at 7, quoting N.J.S.A 48:2-13 and also citing *In Re Proposed Corporate Restructuring of Tele-Communications, Inc*., BPU Docket No.CM90121496, Order dated February 2, 1991.

[230] / *Id.,* at 7, cites omitted.

EXISTING FEDERAL AND STATE POLICIES DO NOT PROTECT CONSUMERS ADEQUATELY

> Ratepayers of utilities face at least three categories of risk when their utility, or its holding company, invests in nonutility businesses. First, the utility holding company investments in non-utility businesses may lead to utility ratepayer subsidies of non-utility services, second, the acquisition of a utility by a holding company can affect the incentives of utility management as new management may have priorities other than local utility service and may lack the State-specific experience necessary to ensure reliable service at reasonable rates. Third, because the utility industry is capital intensive, utilities are highly dependent on access to the capital markets. When the utility's credit ratings decline as a result of activities at the parent holding company or affiliate, the compensation demand by providers of capital can increase, putting ratepayers at risk.[231]

The Board's reasoning in its recent energy order applies equally to the telecommunications and cable industries.

4.4.3. The Cable Act also established Board authority to protect cable ratepayers as cable companies diversify into new lines of business.

Similarly, the Cable Act has the same type of broad provisions that are found in sections of Public Utility Law and these parallel provisions give the Board the same authority to protect cable ratepayers when cable companies diversify into other non-cable businesses, like telephone and Internet services.[232] This broad authority compels that the Board impose appropriate safeguards on both telephone companies and cable companies as part of this rulemaking.

The New Jersey Legislature recognized the importance of consumer protection, stating:

> That, in order to afford an equal opportunity for non traditional MVPD providers such as local telephone common carriers to compete with existing providers, and to ensure that customers receive the benefits of a more competitive MVPD market, it is in the public interest to encourage common carriers to enter the MVPD market by adapting the existing regulatory framework to the changed circumstances brought about by recent technological developments while allowing the State to retain its necessary and appropriate regulatory oversight with regard to consumer protection and customer service elements; and
>
> That nothing in this act shall be seen to limit or otherwise reduce the protection afforded to cable television customers, and it is in the public interest to include additional provisions in this act to ensure that customers

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231 / *Energy Competition and Public Utility Holding Standards*, at 4.

232 / P.L.1972, c.186 (C.48:5A-1 *et seq.*), as amended and supplemented.

continue to be provided a high level of consumer protection and customer service in a more competitive MVPD market.[233]

4.5. Drawing upon relevant federal and state precedent, analysis, and models, the Board can establish workable and fair safeguards to protect consumers and competitors from improper cross-subsidization.

This chapter describes existing federal and state mandates to prevent improper cross-subsidization as well as salient aspects of federal and state models for safeguards. As this chapter demonstrates, although the federal and state statutory mandates to prevent cross-subsidization are unambiguous, the Board lacks the requisite regulatory tools to ensure accountability by the industry in complying with this mandate. Chapter 5 describes the key elements of such tools.

[233] / P.L.1972, c.186 (C. 48:5A-2, §§ g and h).

5. RATE COUNSEL PROPOSAL TO PROTECT CONSUMERS

5.1. Improved safeguards are required to guide the state's development of an advanced infrastructure.

As the previous chapters demonstrate, the existing federal and state regulatory frameworks are inadequate to protect Verizon's telecommunications customers from subsidizing Verizon's FiOS-based entry into video services and to protect the cable industry's customers from subsidizing cable industry's entry into telephone service. The structural separations between telecommunications and cable operations by Verizon and incumbent cable operators would enable the Board to ensure that rates are just and reasonable, and that companies in New Jersey do not engage in improper cross-subsidization. The FCC's decision in 2005 to decline to require Verizon and other Bells to provide unbundled fiber to competitors[234] is another reason that Verizon should conduct its new lines of business separately from its intrastate regulated operations. Also, Verizon's *pro forma* financial statements for its cable operations do not include the cost of using the telecommunications network.[235] With this type of major diversification, circumstances have changed substantially since the Board issued the *PAR-2 Order*.

The benefits of such safeguards to consumers, competitors, and the New Jersey economy are significant. The safeguards will protect consumers from bearing the costs and risks of incumbents' entry into new lines of business. The safeguards also will facilitate the development of a robust, economically sound information infrastructure for New Jersey's households and businesses. This chapter provides the fundamental framework for such safeguards.

5.2. Safeguards, by preventing anticompetitive exercise of market power, will encourage the efficient supply of broadband, cable, and telecommunications services.

Presently, the United States ranks 12th in the world in broadband deployment, with 19.2 broadband subscribers per 100 inhabitants.[236] Relying on industry promises is not a reliable way to accelerate New Jersey's development of a globally competitive infrastructure. As one pundit recently observed with reference to net neutrality, "AT&T has promised not to discriminate—not to 'prioritize, degrade, or privilege' based on

[234] / *Wireline Broadband* Order, at para. 87.

[235] / This statement is based upon authors' conversation with Rate Counsel, who reviewed the confidential *pro forma* financial statements submitted with Verizon's application.

[236] / Organisation for Economic Co-operation and Development, http://www.oecd.org/document/9/0,2340,en_2649_34223_37529673_1_1_1_1,00.html. Denmark leads the world with 29.3 broadband subscribers per 100 inhabitants.

'source, ownership, or destination.' And if AT&T indeed plays by those rules, its expanded size and efficiency may do much to restore America's slipping status in the Internet world."[237] The key question is whether AT&T and other Bells will "play fair."[238] Similarly, in New Jersey, the degree to which the Board allows Verizon and the cable industry to wield their dominance will affect the state's broadband infrastructure. Turning over consumers' pocketbooks to the industry is not an economically efficient way to ensure deployment.[239]

5.3. Broad-based support for net neutrality provides compelling evidence of support for consumer protection.

The unprecedented net neutrality provisions of the AT&T/BellSouth merger,[240] the recently introduced federal legislation to protect net neutrality,[241] and broad citizen support for net neutrality[242] all provide compelling evidence of broad-based concern about leaving the future of the nation's information infrastructure in the hands of a cable-telco duopoly. Similarly, it would be imprudent for the Board to allow the cable and telco industries in New Jersey to dictate the terms of their entry into each others' turf without adequate oversight of the way in which they assign, allocate, and recover costs.

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[237] / "Ma Bell is back, should you be afraid," Tim Wu, www.slate.com, posted January 4, 2007.

[238] / The net neutrality provision that the AT&T/BellSouth merger encompasses is tenuous not only because it has a two-year lifespan, but also because two of the FCC commissioners do not seem to support the goal of net neutrality. They stated: "[fo]r example, today's order does not mean that the Commission has adopted an additional net neutrality principle. We continue to believe such a requirement is not necessary and may impede infrastructure deployment." *In the Matter of AT&T and BellSouth Corporation Application for Transfer of Control*, WC Docket No. 06-74, Joint Statement of Chairman Kevin J. Martin and Commissioner Deborah Taylor Tate. To the extent that the FCC fails to provide consumer protections to Bells' customers, Board oversight to ensure that Verizon and the cable industry compete fairly becomes that much more important.

[239] / Furthermore, unlike in AT&T's region, consumers in the Verizon-served New Jersey region lack the benefit of the commitment to affordable broadband that the recent AT&T/BellSouth merger conditions provide. Verizon's promises to deploy the pricier FiOS platform throughout the state will not provide benefits to consumers seeking more affordable ways to access the Internet. As Table 3, *supra*, shows, consumers pay $39.95 for stand-alone FiOS-based access to the Internet. Verizon's DSL-based Internet, by comparison, is $19.95, and AT&T's comparable service is $10.00. Although FiOS offers superior speed and capability, some customers seek a lower capacity and more affordable way to access the Internet. Verizon's push to deploy FiOS will likely distract it not only from installing and repairing basic telephone service in a timely manner, but also from deploying DSL at an affordable rate.

[240] / *In the Matter of AT&T and BellSouth Corporation Application for Transfer of Control*, WC Docket No. 06-74, FCC News Release, "FCC Approves Merger of AT&T Inc. and BellSouth Corporation," December 29, 2006; AT&T/BellSouth Merger Conditions.

[241] / A bill, with bipartisan support, the "Internet Freedom Preservation Act" (S. 215), was introduced on January 9, 2007, by Senators Byron Dorgan and Olympia Snowe.

[242] / *See, e.g.,* www.savetheinternet.com; www.freespress.net; www.itsournet.org.

If there were sufficient competition in the provision of information pipes, support for protecting net neutrality likely would not be so widespread. The same lack of competition that has propelled nationwide cries for net neutrality also implicates the converging telco-cable industry in New Jersey and is compelling evidence of concern about the market power that the cable-telco duopoly exerts.

As Chapter 2 demonstrates, the Hatfield-McCoy cable-telco rivalry does not represent sufficient competition. Morever, their efforts to squelch municipal pursuit of broadband belie their attempt to persuade regulators that the market is competitive.[243]

5.4. Regulated services should be compensated for the use of common network and resources that support new lines of business.

Verizon reports in the October 30, 2006 *Investor Quarterly* that 7.5 million customers subscribe to its Freedom packages.[244] Consumers of bundled services, such as the Freedom package, are prime candidates for bundled services via FiOS. In fact, Verizon executives tout the effect that FiOS has on bundles. In a conference for industry analysts, a Verizon executive states that 99% of all FiOS customers take at least two products and that 79% take three products.[245]

Verizon's current base of DSL customers are prime targets for its FiOS marketing campaigns, and this contingent is growing quickly. At the end of 2005, New Jersey alone had 540,382 DSL connections and 1,205,182 cable-based high-speed modem lines.[246] Verizon likely serves the vast majority of these New Jersey DSL connections and will likely to seek to convert these households into FiOS subscribers. Figure 10 shows the substantial increase in demand for DSL in New Jersey between year-end 2000 and year-end 2005.

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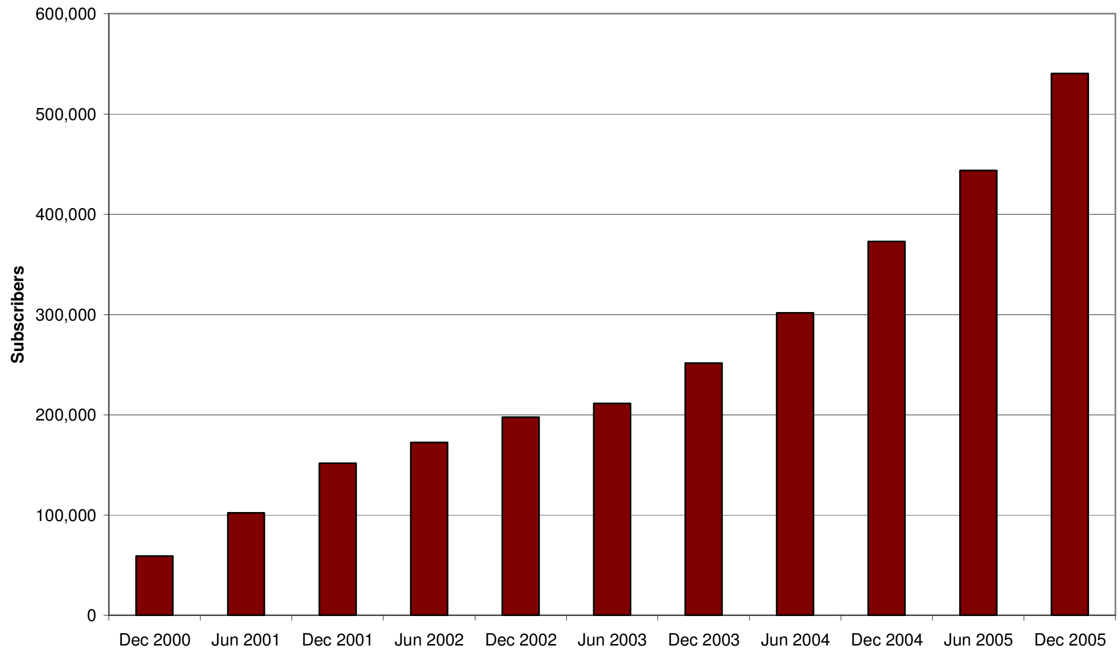
[243] / *See,e.g.,* http://www.onthemedia.org/transcripts/2007/01/05/05.

[244] / Verizon Communications, *Investor Quarterly: Third Quarter 2006*, October 30, 2006, at page 6.

[245] / Verizon FiOS Briefing Session, at page 5.

[246] / *FCC High-Speed Services July 2006 Report*, at Tables 11 and 12.

Figure 10
New Jersey's DSL Subscriber Base Has Grown 811% in Five Years



Source: FCC, *High-Speed Services for Internet Access: Status as of December 31, 2005*, July 2006, Table 11.

5.5. Verizon's cable operations should compensate Verizon's telco operations for the value of the Verizon brand.

Verizon's success in marketing and selling cable services to New Jersey consumers will be based in large part on the Verizon "brand" and the widespread name recognition it has acquired by virtue of supplying New Jersey households and businesses for more than a century.[247] The FCC, in its order addressing Bells' long-distance entry, observed that "the BOCs and other firms, notably existing interexchange carriers, will be able to offer a widely recognized brand name that is associated with telecommunications services."[248] With the substantial concentration that has occurred in the market, the value of Verizon's brand name has increased. Therefore, Verizon should compensate its regulated operations accordingly.

[247] / By way of illustration, Verizon recently spun off its directory publishing operations for approximately $2 billion in cash and a reduction of Verizon's debt by $7 billion. Verizon Communications, Inc., "Verizon CFO Provides Updates on Initiatives to Enhance Shareholder Value," December 6, 2006. The value of Verizon's directory publishing operations is attributable in large part to its historic role as the incumbent local telephone company.

[248] / *Non-Accounting Safeguards Order*, at para. 7.

5.6. Structural safeguards, whereby the telco and cable lines of business are conducted in separate operations, would protect consumers most effectively.

The previous chapters and the accompanying appendixes demonstrate that the telco and cable industries possess the incentive and the ability to subsidize competitive pursuits with revenues from noncompetitive products and with common and joint resources. Verizon has not demonstrated to the Board that Verizon has compensated adequately its regulated intrastate operations for its unique access to a ubiquitous base of customers and to a ubiquitous public switched network, which it uses to the benefit of its DSL and FiOS-based services.

Furthermore, as Chapter 2 shows, there is insufficient competition in today's cable and telco markets to discipline rates for basic telecommunications services and for basic cable services.[249] Finally, if Verizon's multi-billion entry into the cable market proves unprofitable, structural separations will protect future generations of ratepayers.[250] For these various reasons, the Board should establish rigorous safeguards to address the market failure and existing regulatory vacuum. The goal of the safeguards is to prevent anticompetitive abuse, to protect consumers from firms' power to raise and sustain rates above competitive levels, and to encourage the economically efficient supply and deployment of an advanced information infrastructure throughout New Jersey.

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[249] / The options that are emerging for triple and quadruple play customers do not discipline the rates, terms, and conditions for basic local exchange and basic cable services. The idea that competition for customers seeking bundles somehow protects the customer who seeks only basic "no-frills" local exchange service is nonsensical. Instead, Bells are pursuing "high-end" customers and neglecting the low-revenue customers. The market's abandonment of the basic customer became evident in 2004 when AT&T announced its intention to "harvest" mass market customers. Citing among other sources, AT&T Declarant John Polumbo and the Q4 2004 AT&T Earnings Conference Call, the FCC states, "[w]e base this conclusion on AT&T's cessation of marketing, its reductions in consumer operations, its retirement of infrastructure used to support mass market marketing and consumer care for mass market services, and its decision to 'harvest' its mass market business by raising prices, resulting in a declining mass market customer base." *In the Matter of SBC Communications Corp. and AT&T Corp, Inc. Applications for Approval of Transfer of Control*, FCC WC Docket No. 05-65, Memorandum Opinion and Order, Rel. November 17, 2005 ("SBC/AT&T Merger Order"), at para. 313. The FCC explains further that "'[h]arvesting' refers to AT&T's increasing prices to encourage customers to discontinue service" and that "'[h]arvesting' refers to AT&T's steps to manage the decline in its mass market business." *Id.*, at fn 313.

[250] / Experience in the electric industry may be instructive. Federal and state regulators, anticipating that competition would yield lower prices, eliminated many forms of rate protection for consumers of electricity. A decade later, consumers are seeing rate increases, and the anticipated competition has failed to materialize. "Competitive Era Fails to Shrink Electric Bills: More Increases Are Seen – Some States Are Seeking to Return to a System of Regulated Prices," *The New York Times*, October 15, 2006, at 1. Also, while consumers confront rate increases, investors, which purchased power plants, are reaping vast profits. "In Deregulation, Power Plants Turn Into Blue Chips," *The New York Times*, October 23, 2006, at 1. Absent adequate regulatory protection and proper cost accounting, consumers of intrastate telecommunications regulated services will be at risk of future rate increases.

Measures to prevent improper cross-subsidization need to be balanced with the goal of allowing firms to benefit from economies of scope, that is, the more a firm integrates its operations the lower its costs may be.[251] A trade-off exists between the efficiency of integrated operations and the potential for improper cost allocation, similar to that recognized by the FCC in its establishment of safeguards that originally governed Bells' entry into the long-distance market.[252] In today's regulatory environment, the scales are tipped toward improper cost-allocation. As Bells enter cable territory and as cable companies enter telco territory, safeguards to minimize improper cross-subsidization are essential. By way of illustration, as Chapter 4 discusses, the FCC established safeguards to guide Bells' entry into long distance services. Among other things, the FCC reasoned as follows:

> We agree with the claims of some commenters that, because the costs of wired telephony networks and network premises are largely fixed and largely shared among local, access, and other services, sharing of switching and transmission facilities may provide a significant opportunity for improper allocation of costs between the BOC and its section 272 affiliate.[253]

The Board now confronts a similar situation, which necessitates similar measures. Where costs are largely fixed and shared, there is a significant opportunity for improper cost allocation and discrimination. The safeguards should:

- Ensure that new lines of business compensate regulated lines of business for any use of shared expertise, resources, personnel, tariffed services, and/or other assets.

- Eliminate the incentive for Verizon's telco operations to favor Verizon's cable business, and eliminate the incentive for cable companies' operations to favor their own telco business.

The Board should permit a common corporate parent, but require structurally separate affiliates, whereby the affiliates operate independently, based on the Section 272 long-distance model. The separate affiliate requirement would sunset and integrated operations could occur only upon an affirmative finding by the Board that sufficient alternative safeguards existed.

At a minimum, the Board should establish regulations that:

- Require Verizon and incumbent cable operators to maintain separate books of account for their telco and cable businesses.

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[251] / Economies of scope occur when it is less costly for a single firm to provide a bundle of goods than for two or more firms to provide them separately.

[252] / *Non-Accounting Safeguards Order*, at para. 13.

[253] / *Id.*, at para. 159, cite omitted.

RATE COUNSEL PROPOSAL TO PROTECT CONSUMERS

- Prevent joint ownership of facilities with affiliates.
- Require the affiliate to obtain any services at tariffed rates and conditions.
- Prohibit the incumbents from discriminating between affiliates and other entities.
- Require incumbents and their affiliates to conduct any joint research and development on a compensatory basis.
- Require the incumbent to put in writing any transactions between the separate subsidiary and its affiliates.
- Require the affiliates to negotiate on an arm's length basis.
- Require the incumbents to submit clear descriptions of cost accounting and cost allocation methodology to the Board and to the Rate Counsel.
- Require the incumbents to maintain a complete audit trail of all cost allocation and affiliate transactions.
- Require the submission of annual reports to the Board and to the Rate Counsel specifying incumbents' relative levels of investment and employment in their intrastate regulated operations separately from corresponding levels in their new lines of business.
- Require incumbents to maintain books, records, and accounts separate from their new lines of business.
- Establish an expedient complaint process for allegations of cross-subsidization
- Either prohibit sharing of marketing personnel or allocate shared personnel costs based on fair market value.
- Establish service quality standards, and, as is necessary, financial incentives to ensure the adequacy of basic telecommunications and cable services.
- Require the incumbents to submit to the Board and to Rate Counsel, on a quarterly basis, financial reports, an income statement, a balance sheet, and a statement of cash flows separately for incumbent line of business and new lines of business.
- Require annual audits of sales practices.

- Impose penalties for non-compliance with cost accounting and service quality regulations.

The Board should ensure that Verizon and the cable industry offer their new lines of business on an arm's length basis to minimize the opportunities for anti-competitive behavior.

The goals of these safeguards are to:

- Encourage competition to develop on an equal footing.
- Ensure that Verizon NJ and the cable industry do not neglect the quality of their basic services in their rush to compete in the converged triple play market.
- Protect consumers from the cost and risk of the industry's entry into new markets.

The most effective way to prevent improper cross-subsidization is to require the creation of distinct affiliates with accounting and non-accounting safeguards. As a second best approach, the Board should establish a comprehensive and feasible set of non-structural safeguards to detect and to deter improper cross-subsidization. The safeguards should ensure, among other things, that:

- New lines of business compensate the incumbent operations for any employee transfers and reliance on shared personnel.
- New lines of business compensate the incumbent operations for the value of the incumbent's "brand."
- The incumbents' books and transactions are clearly maintained and that their books are subject to annual audits.
- Verizon provides detailed and lucid explanations of the way in which it assigns and allocates costs associated with its FiOS and cable operations. As an integral component of its filing, Verizon should identify any and all joint and common resources (including, but not limited to common physical network plant, office space, management, sales and advertising, general support and administrative expenses, etc.).
- Verizon demonstrates that its FiOS-related and cable revenues cover their associated costs, and, in the absence of such a showing, demonstrates that revenues from its regulated operations are not being used to subsidize its entry into new lines of business.

- Incumbents describe clearly and thoroughly to the Board the way in which they charge their unregulated lines of business for use of common resources.

- The accounts, cost methodology, and finances of the company's regulated and nonregulated operations are subject to annual audit by third party.

- Sales practices are subject to annual audits.

- Penalties for non-compliance with regulatory safeguards and service quality standards exist.

5.7. Enforcement measures are essential to counteract the economic incentive to engage in improper cross-subsidization.

Regardless of whether the Board establishes structural or non-structural safeguards, the design and implementation of feasible and effective enforcement measures are essential to protect consumers from paying high rates for basic telephone and cable services and to ensure that competitors have a fighting chance of competing with the Goliath-like cable-telco duopoly that now dominates the information pipes in New Jersey. A key element of the enforcement should include provisions for audits.

When confronted with Verizon's request to discontinue the auditing condition of the Bell Atlantic/GTE merger, the FCC stated:

> We reject Verizon's claim that these compliance requirements obviate the need for the independent auditor condition. As previously stated, the Commission found that the compliance program protected the public interest, but only in conjunction with the independent auditor condition. A quarterly report or compliance reports is not a substitute for an independent auditor condition. Verizon's obligations to file unaudited quarterly and compliance reports do not provide an independent review of Verizon's performance. During the audit process, the Commission staff, state commissions, and independent auditor have access to the working papers, supporting materials, and interpretations underlying Verizon's compliance assertions that may not be disclosed in the performance reports or available to third parties. Finally, when contemplating the merger, the Commission considered the independent auditor condition a useful tool to supplement its usual investigative authority. In view of the foregoing, we find no reason to alter our prior conclusion that the compliance mechanisms discussed in Verizon's request are not substitutes for the independent auditor condition.
>
> Lastly, Verizon contends that we should discontinue the audit requirement because "the audits for the years 2005 and beyond would cost at least one million dollars," and "the burdens of continued audits clearly outweigh

> any possible benefits." We find this contention unpersuasive. The Commission specifically found that "the audit requirement establishes an efficient and cost-effective mechanism for providing reasonable assurance of Bell Atlantic/GTE's compliance with the conditions." Verizon has not provided substantial evidence to contradict this finding. We conclude that, therefore, Verizon has not demonstrated that discontinuing the independent auditor condition would serve the public interest.[254]

5.8. The Board should seek information from the industry so that it can fulfill its mandate to prevent improper cross-subsidization.

Through its general supervisory authority and mandate to ensure that rates are just and reasonable, and to comply with New Jersey's statutory prohibition on improper cross-subsidization, the Board should issue a detailed data request to Verizon and to cable companies. These questions should seek information about the personnel, plant, and any other resources that are shared among the incumbent's basic operations and its new lines of business.

The Board should also direct Verizon and incumbent cable operators to submit cost allocation manuals and comprehensive financial statements about their operations. Furthermore, the Board should obtain a list of all intrastate regulated tariffed services upon which Verizon's cable-telco bundles rely, and a description of the method of compensation, if any, to Verizon NJ's intrastate regulated services. Verizon NJ should be directed to describe fully all network, personnel, advertising and other resources of Verizon NJ's intrastate regulated operations upon which Verizon's FiOS operations rely and to describe the method of compensation to Verizon NJ's intrastate regulated services.

Verizon and the incumbent cable operators also should provide detailed annual information for the past five years, and on an ongoing basis, about their investment in and quantities of employees assigned to their basic services to enable the Board to assess whether they are investing sufficiently to provide adequate service to households and businesses in New Jersey.

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[254] / *In the Matter of GTE Corporation, Transferor, and Bell Atlantic Corporation, Transferee, for Consent to Transfer of Control of Domestic and International Sections 214 and 310 Authorizations and Application to Transfer Control of a Submarine Cable Landing License*, FCC CC Docket No. 98-184, EB File No. EB-04-IH-0143, *Order*, released January 7, 2005, paras. 7-8, footnotes omitted.

6. CONCLUSION

The convergence of cable and telco services may yield consumer benefits in the form of lower rates, higher service quality, and product innovation. Presently, however, market forces do not constrain the pricing of noncompetitive services. Neither the existing interstate price cap system nor the existing intrastate *PAR-2* regulation yields rates and service quality that would prevail in a competitive market. Therefore, during the transition to effective competition, regulatory oversight and intervention are essential to ensure that basic cable rates do not subsidize entry into the phone business and to ensure that basic phone rates do not subsidize entry into the cable business. At a minimum, tools for monitoring cost accounting and allocation are essential to protect consumers of monopoly (or near-monopoly) cable and telco services from footing the bill for the industry's entry into new markets. Structural safeguards are essential to prevent improper cost allocation and to ensure that consumers benefit from innovation, service quality, just and reasonable rates, and diverse supply as New Jersey builds its information network.

Authors: The authors have provided policy recommendations and technical assistance to the Rate Counsel on diverse issues such as mergers, separations reform, competitive reclassification, and market structure analysis.

Susan M. Baldwin has been working in public policy for 29 years, and in the field of telecommunications policy and regulation for 23 years. She served as the Director of the Telecommunications Division for the Massachusetts Department of Public Utilities (now the Department of Telecommunications and Energy), was a senior vice president for Economics and Technology, Inc., has testified before 16 state public utility commissions, has participated in numerous Federal Communications Commission proceedings, and has served as a consultant to consumer advocates, regulators, and new entrants. For the past six years, Ms. Baldwin has been consulting to public sector agencies on telecommunications economics, regulation, and policy. Ms. Baldwin received her Master of Economics from Boston University, her Master of Public Policy from Harvard University's John F. Kennedy School of Government, and her Bachelor of Arts degree in Mathematics and English from Wellesley College.

Sarah M. Bosley has over seven years of experience in telecommunications economics, regulation, and public policy. Most recently, she has been providing services to public sector agencies as an independent consultant. Ms. Bosley conducts economic analysis and research and contributes to expert testimony in numerous state and federal regulatory proceedings. She has contributed to and co-authored reports to state commissions, white papers, and comments and declarations filed in Federal Communications Commission proceedings. Ms. Bosley's experience includes the analysis of a broad range of public policy issues, including: intercarrier compensation and access charge reform; universal service policy; mergers and market concentration; local competition; and alternative regulation. Ms. Bosley earned her Master of Science in Agricultural and Applied Economics from Virginia Tech, her Master of Arts in International Affairs from American University's School of International Service, and her Bachelor of Arts in Political Science from McGill University

Timothy E. Howington has over three years experience analyzing the telecommunications industry and previous experience in economic development. Mr. Howington has contributed to testimony filed in numerous state and federal regulatory proceedings on behalf of consumer advocates. Mr. Howington has analyzed market concentration, service quality, and several telecom mergers. In addition, he has researched areas such as net neutrality, high-cost universal service support, and intercarrier compensation reform. Mr. Howington earned a Master of Arts in Economics from Boston University and a Bachelor of Arts in New Eastern Languages and Civilizations from the University of Chicago.

Contact information:

Susan M. Baldwin
17 Arlington Street ▪ Newburyport, MA 01950
smbaldwin@comcast.net ▪ (978) 255-2344

Appendix 1

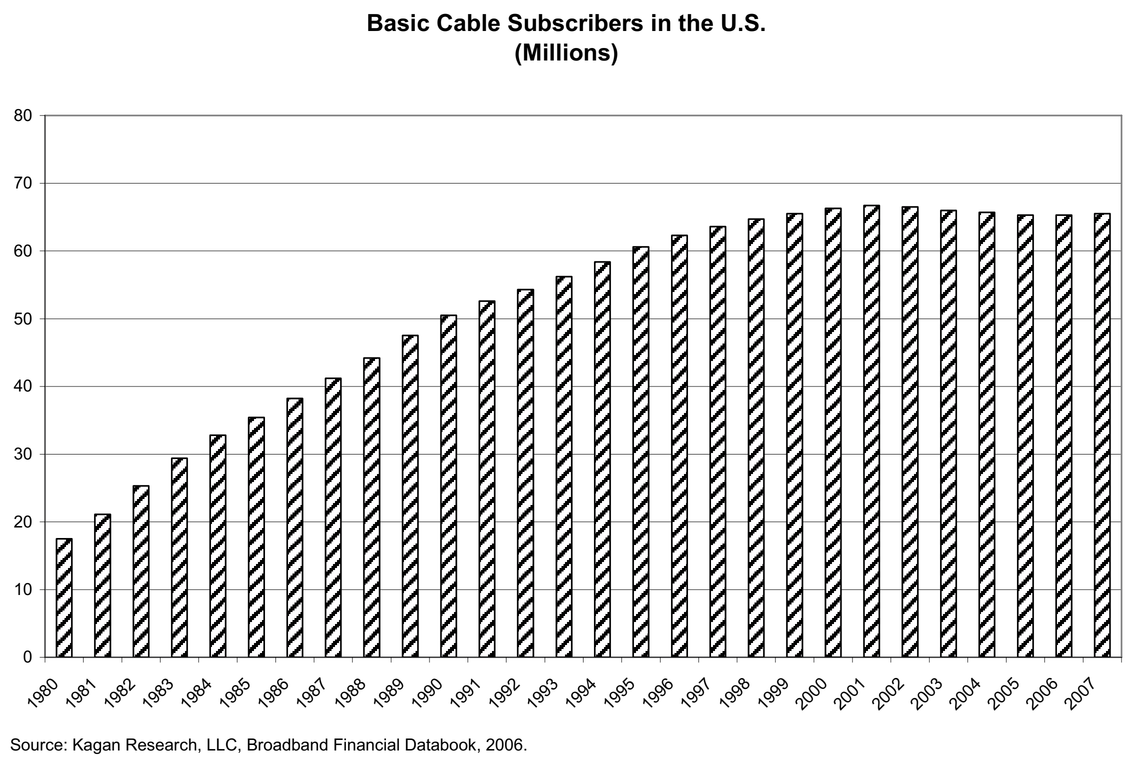
The Cable Television Industry

Overview of the National Cable Industry

According to the National Cable and Telecommunications Association ("NCTA"), the national trade association, the United States cable industry will earn $74.7 billion dollars in 2007.[1] This Appendix highlights several other statistics demonstrating the ubiquity and importance of the cable industry.

According to the FCC, "Basic Cable Service" is

> [T]he level of cable television service that must be taken by all cable television subscribers. The content of basic cable service varies among cable systems but, pursuant to the Communications Act, must include all local television signals and public, educational, and governmental access channels and, at the discretion of the cable operator, may include other video services. [2]



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[1] / NCTA website, "Industry Statistics," available at http://www.ncta.com/ContentView.aspx?contentId=54 ("NCTA Industry Statistics").

[2] / *In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, MB Docket No. 05-255, Twelfth Annual Report, Adopted: February 10, 2006, Released: March 3, 2006 ("Twelfth Annual Report"), at footnote 17.

Although the industry is dominated by a few key players, such as Cablevision, Comcast, and TimeWarner Cable, there were approximately 7,090 cable systems operating in the U.S in 2006.[3] The industry as a whole counts over 65 million households as customers, giving the industry a penetration rate of 58.9% of all U.S. households with televisions.[4]

Number of Subscribers for Top Three Cable Companies
(Third Quarter 2006)

	Cablevision	Comcast	Time Warner Cable
Basic Cable	3,110,800	24,100,000	13,471,000
Digital Cable	2,364,335	12,100,000	7,024,000
High Speed Cable Internet	1,963,880	11,000,000	6,620,000
Cable-based Telephony	1,100,628	2,100,000	1,649,000

Source: company websites and earnings releases for Q3 2006.

The cable industry has expanded its offerings over the past decade to benefit from the increasing importance of the Internet. According to the web site of the New Jersey Cable and Telecommunications Association, the cable industry's increases in investment in technology and infrastructure were a direct result of the deregulatory environment introduced by the 1996 Telecommunications Act.[5] Some of the non-traditional services now offered by cable companies include digital cable, high-speed Internet access, cable-based telephony, and video-on-demand.

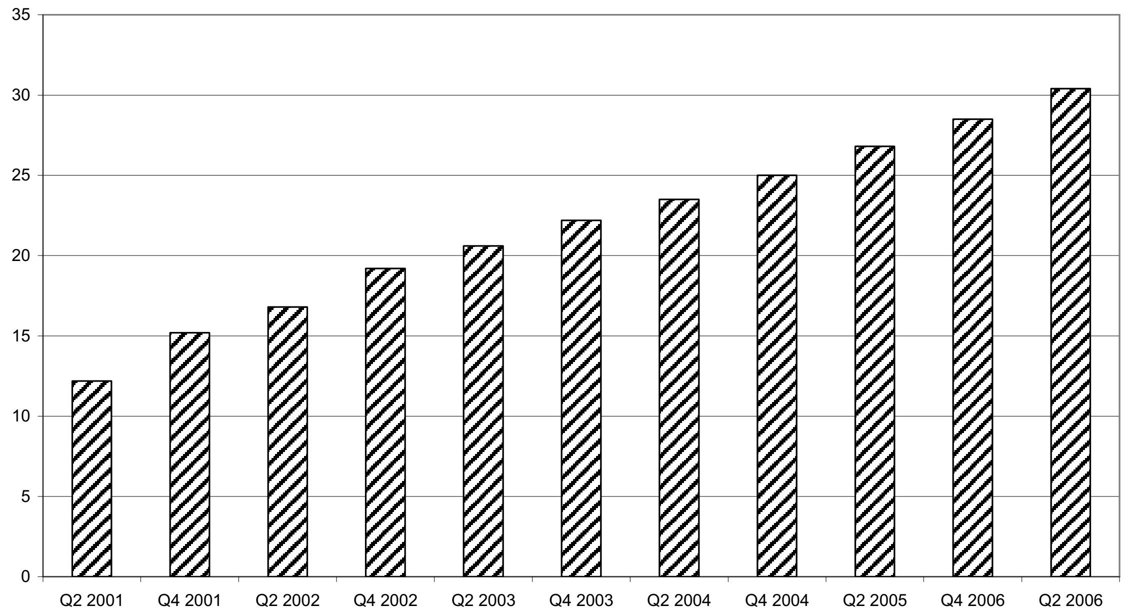
[3] / *Id.*

[4] / *Id.*

[5] / *See* http://cablenj.org/facts_cable.asp#4 (accessed January 12, 2007).

By the second quarter of 2006, the cable industry served more than 31 million digital cable customers nationwide.

U.S. Digital Cable Customers, 2001 to 2006
(Millions)



Source: Kagan Research, LLC, Broadband Financial Databook, 2006.

The FCC' *Twelfth Annual Report* notes:

> Digital cable subscribers typically rent a digital set-top box from the cable company and receive some free digital video service. Digital cable subscribers obtain video programming by purchasing one or more digital service tiers. Digital tiers provide a variety of programming similar to basic tiers or theme tiers, such as a movie tier, a sports tier, and a non-English-language tier. Digital cable subscribers may also purchase one or more premium digital tiers, such as HBO, Showtime, Cinemax, The Movie Channel, Starz!, and international programming. A high-definition service tier also is available to many digital cable subscribers. In addition, cable operators are offering interactive digital services to digital cable subscribers, such as digital video recorders and video-on-demand. All of these digital services are available to subscribers with analog televisions that use a digital set-top box that converts digital signals to analog.[6]

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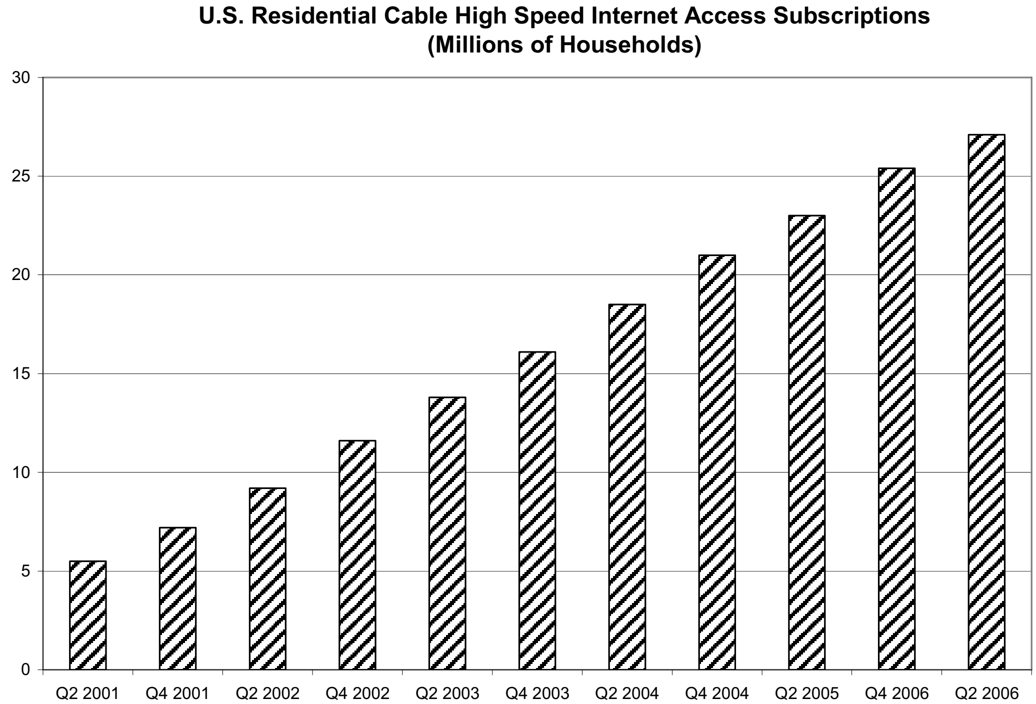
[6] / *Twelfth Annual Report*, at paragraph 55. The FCC set a deadline of July 1, 2007, for all cable operators to make their services compatible with boxes from third-party manufacturers. "Atop TV Sets, Basic Black Boxes Face Competition," Brad Stone, *The New York Times*, C1, January 17, 2007.

Of the 112 million occupied homes passed by cable, nearly 108 million have access to cable high speed Internet services. Of those households where high speed cable access is available, 28 million households subscribe to the service.[7]



Source: Kagan Research, LLC, Broadband Financial Databook, 2006.

The FCC reports that cable operators are offering differentiated Internet access services – products with slower throughput at relatively lower rates and other, faster products marketed to those willing to pay higher rates.

> Over the past year, many cable operators have increased the speed of their high-speed Internet services as well as experimented with lower-priced tiers of service, some as low as $25 per month. Most cable operators are now offering 4 to 6 Mbps downstream and additional high-speed Internet tiers with even faster speeds. NCTA says that the cable industry has developed technical specifications that will enable operators to continue increasing Internet service speeds to 160 Mbps downstream and 60 Mbps upstream [8]

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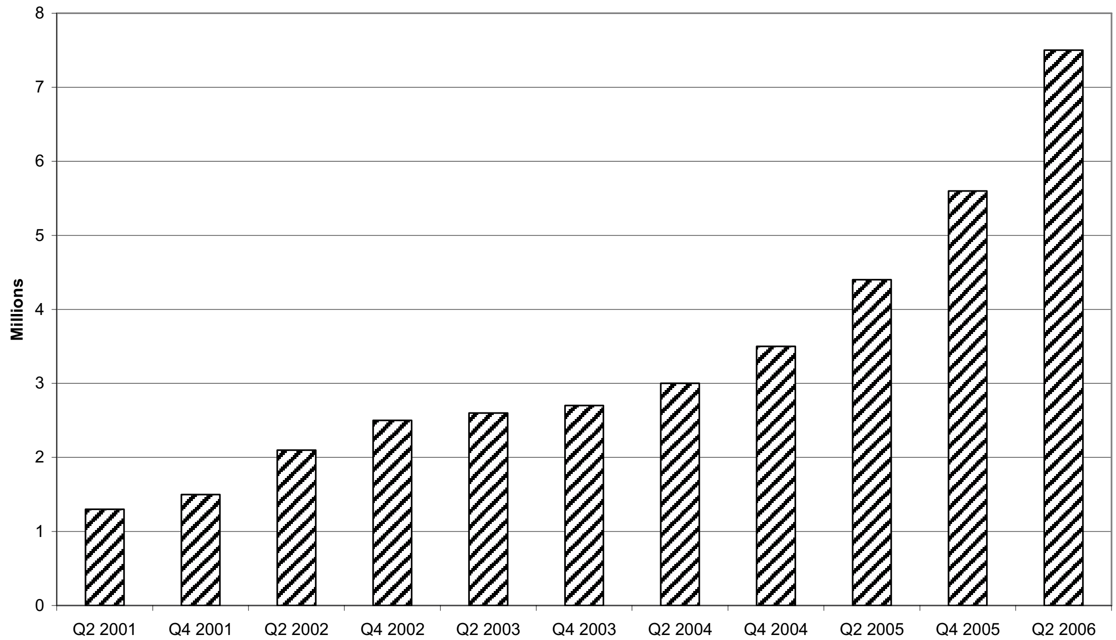
[7] / *NCTA Industry Statistics.*

[8] / *Twelfth Annual Report*, at paragraph 65.

Cable-based telephony, which only became available relatively recently, now serves 8.5 million customers.[9] The FCC notes that the cable industry is now turning from traditional circuit-switched telephony to voice-over-Internet protocol (VoIP) service.[10] The top cable companies report cable-based telephony penetration rates of approximately 10% (Comcast) to 24% (Cablevision).[11]

U.S. Residential Cable Telephony Customers, 2001 to 2006
(Millions)



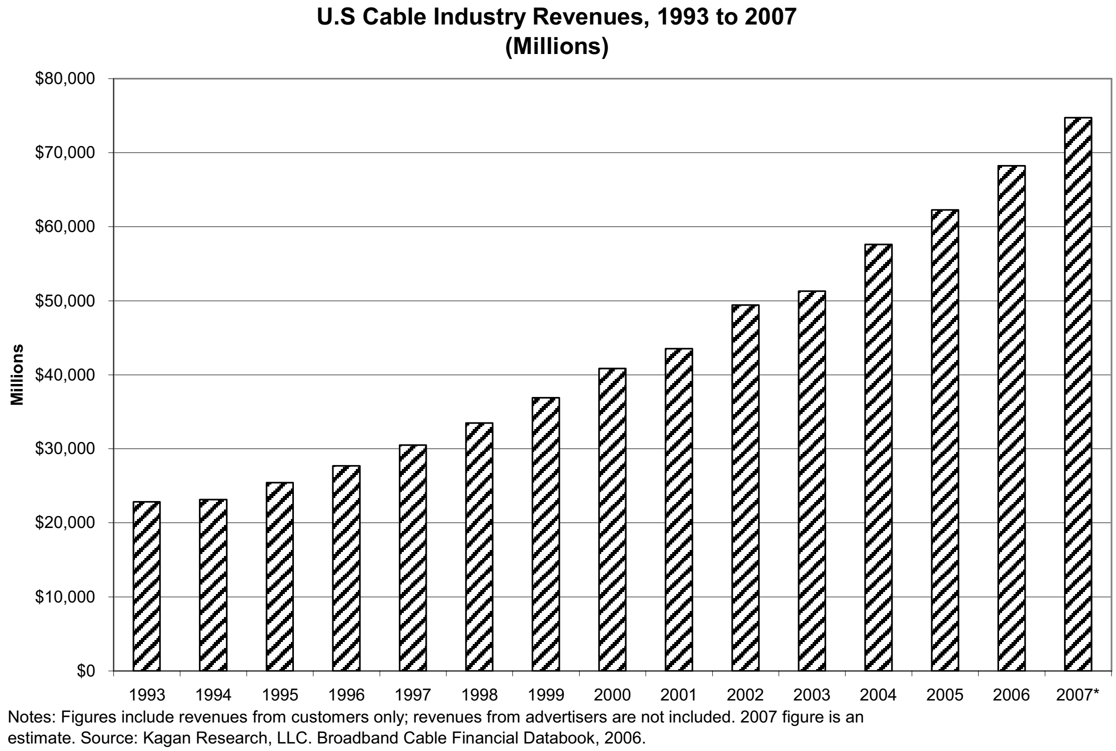
Source: National Cable and Telecommunications Association estimates based on company data. Available at http://www.ncta.com/ContentView.aspx?contentId=61

[9] / *NCTA Industry Statistic*s.

[10] / *Twelfth Annual Report*, at paragraph 66. The FCC describes the difference between circuit-switched and IP-based telephony: "A circuit-switched cable telephony voice call and an IP telephony voice call provided by a cable operator both begin with special equipment that connects a household's twisted pair infrastructure with the cable infrastructure. Cable circuit-switched telephony, however, eventually turns the call over to the public switched telephone network (PSTN), while IP telephony turns the call over to an Internet IP gateway for IP processing onto the PSTN or a managed IP Network. IP telephony processes voice telephone calls much like data on the Internet; that is, digitized pieces of data are divided into discrete packets and are transported over an IP network following any path that does not resist transfer." *Twelfth Annual Report*, at footnote 19.

[11] / Comcast, Cablevision, and Time Warner Cable Q3 2006 quarterly reports.

Although the number of basic cable subscribers declined from its peak in 2001, cable industry revenues soared 57% from 2001 to 2006,[12] in part as a result of the fact that cable rates rose 93% from 1996 to 2006.[13]



The FCC reports that "[m]uch of the increase in revenue comes from advanced services, especially high-speed Internet service and digital cable services, and from higher basic cable rates, which are regulated by local communities."[14]

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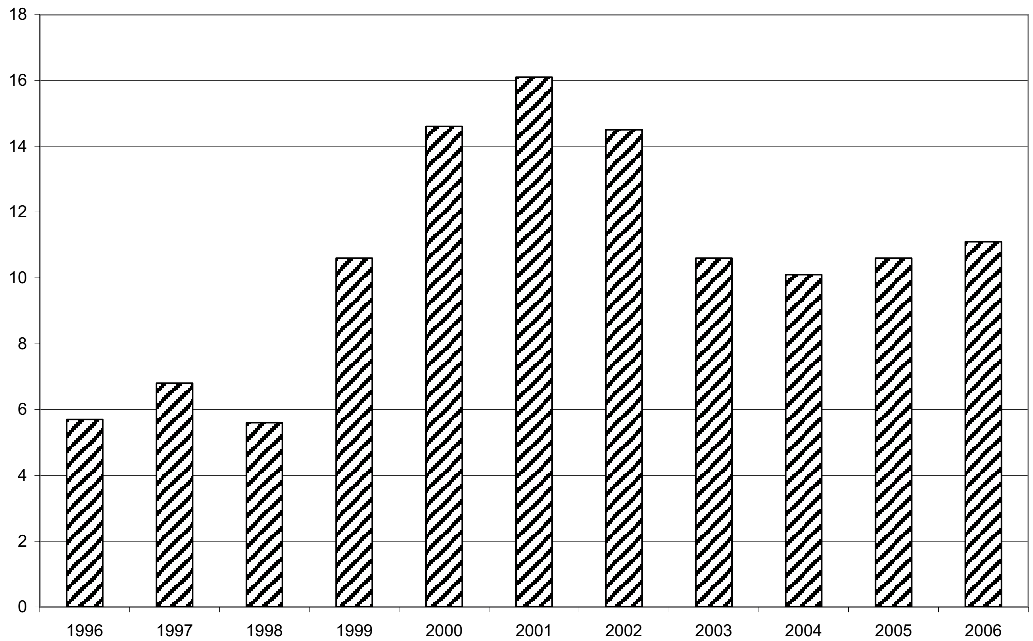
12 / NCTA, citing Kagan Research, LLC. *Broadband Cable Financial Databook, 2006*.

13 / *In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992 and Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment*, MM Docket No. 92.266, "Report on Cable Industry Practices," Adopted: December 20, 2006, Released: December 27, 2006, at 1.

14 / *Twelfth Annual Report*, paragraph 42.

Although investment has slipped from it recent peak in 2001, the cable industry still spends a sizable amount each year maintaining, upgrading, and extending its networks.

U.S. Cable Industry Infrastructure Expenditures
(Billions of Dollars)



Source: Kagan Research, LLC, Broadband Financial Databook, 2006.

The Cable Industry in New Jersey

According to *Cable Facts 2006*, a report produced by the Office of Cable Television of the New Jersey Board of Public Utilities, there were over 2.5 million subscribers to cable services at the end of 2005.[15] These customers were served by 39 cable system operators.[16] The top cable companies, as measured by subscribership, are shown in the following table.[17]

Top Cable Companies in New Jersey

	Subscribers
Comcast Cable Communications	1,366,279
Cablevision Systems	963,576
Patriot Media and Communications	80,004
Time Warner Cable	55,693
Service Electric Cable TV	47,026
US Cable	4,559
Hometown Online	1,268
Total	2,518,405

Source: New Jersey Board of Public Utilities, Office of Cable Television, *Cable Facts 2006*, at page 18.

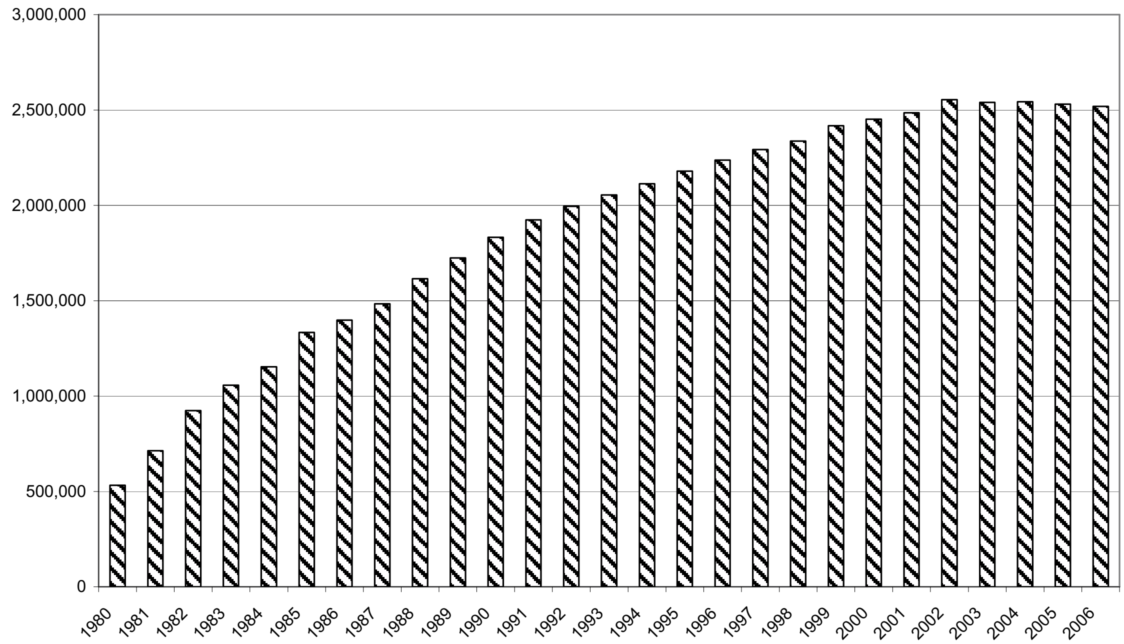
[15] / New Jersey Board of Public Utilities, Office of Cable Television, *Cable Facts 2006*, at page 18.

[16] / *Id.*

[17] / Subscribership figures for the other 32 cable service providers in operating in New Jersey are unavailable.

After showing a steady increase year after year for two decades, cable subscribership in New Jersey leveled off, and then, since 2001, declined slightly.

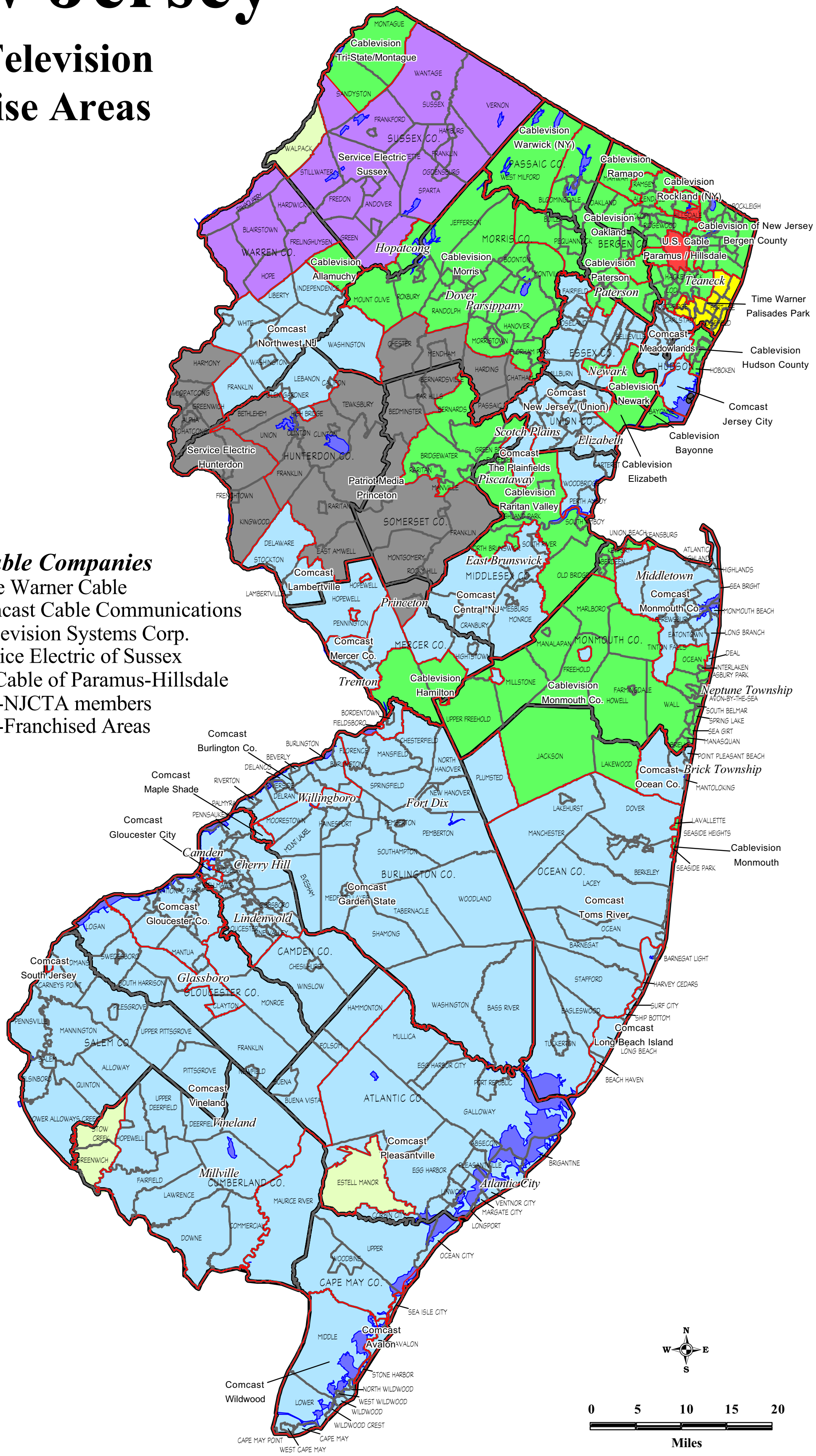
New Jersey Cable Subscribers, 1980 to 2006



Source: Office of Cable Television, New Jersey Board of Public Utilities, Cable Facts 2005, at 33; *Cable Facts 2006* , at 18.

New Jersey

Cable Television Franchise Areas



New Jersey Cable Companies

- Time Warner Cable
- Comcast Cable Communications
- Cablevision Systems Corp.
- Service Electric of Sussex
- US Cable of Paramus-Hillsdale
- Non-NJCTA members
- Non-Franchised Areas

A Selection of Comcast Services Available on a Stand-Alone Basis

Cable Television Services:

- Basic Cable - $8.86
- Digital Classic - $58.86
- Digital Preferred – $63.86
- Digital Preferred with 1 Premium - $78.86
- Digital Preferred with 2 Premiums - $89.86
- Digital Premier - $102.86

Internet Access

- High speed internet for customers with Comcast video service - $29.99 (three months only, then $42.95)
- High Speed Internet without Comcast Cable TV service - $57.95

Telephone Service

- Comcast Unlimited – $66.94

Comcast Bundles

High Speed Internet and Comcast Digital Voice - $69

Triple Play - $99

- Comcast Digital Cable with ON DEMAND
- High Speed Internet
- Comcast Digital Voice

Preferred Plus Bundle - $129.99

- Comcast Digital Cable with HBO/Starz and ON DEMAND
- High Speed Internet
- Comcast Digital Voice

Product Descriptions from Comcast's Website

Digital Classic

See Channel Lineup

Comcast's Digital Classic gives you hundreds of channels, so you'll always find the perfect program for you. You get more news, more movies, and more live concerts that you won't find anywhere else. Unique educational networks give you more great programs for the kids. And, Comcast's Digital Classic package offers you access to ON DEMAND movies and free programming! Hundreds of titles, ready when you are! Now your television will obey you, with ON DEMAND!

$58.86
Add to Cart

+ See All Features

Digital Preferred

See Channel Lineup

Looking to experience a wide world of great movies, sports, kids' programs and music but not into the premium channels? Think Digital Preferred. You'll enjoy more than 100 digital cable channels, and over 45 music channels. You'll get access to our ON DEMAND library of thousands of shows and movies (most of them free) ready to watch when you are. Plus, you'll get great features like our interactive program guide and easy-to-use Parental Controls.

$63.86
Add to Cart

+ See All Features

Digital Preferred with 1 Premium

See Channel Lineup

Includes 1 premium movie network.

Kick back and take in the best movies, sports and kids shows. In addition to your choice of **one premium channel** and its multiplexes, you'll enjoy over 100 digital cable channels, plus 45 digital music channels. You'll experience TV in whole new ways with our ON DEMAND library of thousands of shows and movies (most them free), our interactive program guide, Parental Controls, and more.

$78.86
Add to Cart

+ See All Features

Digital Preferred with 2 Premiums

See Channel Lineup

Includes 2 premium movie networks.

Do you really love TV? (It's OK to say yes.) With this package, you'll get Digital Preferred plus any **two premium channels** and their multiplexes, more than 100 digital cable channels, and over 45 digital music channels. Perhaps best of all, you'll get access to our amazing ON DEMAND library of movies, sports, and kids' programs. Most of them are free and all are ready to watch when you are. You'll get our interactive program guide and Parental Controls, too.

$89.86
Add to Cart

+ See All Features

Digital Premier

See Channel Lineup

Includes 5 premium movie networks.

Our ultimate package loaded with all the movies, sports, kids and entertainment programming you love – much of it available ON DEMAND for free, ready to watch whenever you want. You'll get all five premium channels and their multiplexes, more than 100 digital cable channels, over 45 digital music channels, an interactive program guide, Parental Controls, and much more. An incredible TV experience awaits.

$102.86
Add to Cart

+ See All Features

Offers & Packages	Features Summary	Monthly Price
Basic Cable See Channel Lineup	For local news, area sports coverage and weather forecasts for your neighborhood, Comcast's Basic Cable package more than delivers. Enjoy your favorite local broadcast networks, plus a selection of other cable channels, all at an affordable price. + See All Features	$8.86 Add to Cart

Special Offer

Enjoy scorching speeds up to 4 times faster than 1.5 Mbps DSL, up to 7 times faster than 768 Kbps DSL, and up to 100

$29.99
Add to

High-Speed Internet - Special Offer

times faster than 56 Kbps dial-up!
And now with PowerBoost™, our fast connection gets even faster with an extra burst of speed up to 12 Mbps when you're downloading large files like videos and games. You'll also get free McAfee® security software, up to 7 email account, PhotoShow Deluxe, up to date news and entertainment video clips on The Fan™ and more.

For a limited time, get Comcast High-Speed Internet (6 Mbps) for $29.99/mo for 3 months!

Starting at

$29.99/month for 3 month(s), ongoing price is $42.95/month

+ See All Features

Cart

High-Speed Internet for Non-Comcast Cable TV Customers

Stop crawling the web and start burning rubber with scorching speeds up to 4 times faster than 1.5 Mbps DSL, up to 7 times faster than 768 Kbps DSL, and up to 100 times faster than 56 Kbps dial-up! You'll get free tools like McAfee® security software to keep all your info and computer safe. And with Comcast.net, you'll get amazing free content and features like The Fan™ Video Player, your one-stop source for the best online video.
+ See All Features

$57.95
Add to

Comcast Unlimited™

Now you can call anyone, anytime, anywhere in the country — all for one low price. But that's just the beginning. This includes calls to Canada, Puerto Rico, US Virgin Islands, Guam, and Saipan/N. Mariana Islands. You'll get advanced features like online Voice Mail access and the popular features you expect, like call waiting. You can even keep your current phone number and phone. And of course you'll enjoy the simplicity of one bill for all your Comcast services.
+ See All Features+ See International Rates

$66.94
Add to
Cart

High-Speed Internet and Comcast Digital Voice Bundle

Close Window

Get Comcast Digital Voice and High-Speed Internet together in one package for just $69/month for 12 months when you sign up for both services. It's a great value. This package is designed for new customers and includes:

Comcast High-Speed Internet
Download music, photos and videos way faster than DSL and Dial up. Plus, get McAfee virus protection, firewall and parental controls.

Comcast Digital Voice®
Enjoy unlimited local and nationwide long distance calls so you can talk as much as you want. Plus, Voice Mail with web access,12 popular calling features like Caller ID, 3-Way Calling and Anonymous Call Blocking. Online account summary and call detail. Keep your number or change it - you decide.
EMTA required for an additional monthly fee.

Note: Price after 12 month promotional period will vary depending on your area and level of service chosen at that time.

Get Comcast Digital Voice and High-Speed Internet together in one package for just $69/month for 12 months when you sign up for both services. It's a great value. This package is designed for new customers and includes:

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EMTA required for an additional monthly fee.

Note: Price after 12 month promotional period will vary depending on your area and level of service chosen at that time.

The *High-Speed Internet and Comcast Digital Voice Bundle* package you have selected includes the following:

Comcast High-Speed Internet: Comcast High-Speed Internet:

Content:
Enjoy full access to Comcast.net, our dynamic Internet launching pad that's your starting point for news, e-mail, video mail and much more. (Read more about Comcast.net below.)

Access friendly, experienced customer support 24 hours a day, seven days a week, and tap into a variety of helpful online self-service tools, real-time chat and e-mail. Visit the Service Center often to view answers to frequently asked questions, read the latest virus alerts or change your password. Comcast.net puts tons of information at your fingertips.

You'll have full privileges on Comcast.net, the exclusive portal that gives you instant access to a world of tools, videos, information and fun. Here are just a few of the exciting features on Comcast.net:

McAfee Security: Protect your computer and personal information with top-rated McAfee Virus Protection, Firewall, and parental controls.
Rhapsody Radio PLUS: Create your own commercial-free, customizable radio stations, access over 2 million songs, watch music videos and much more - all free.
Comcast Toolbar: Get free pop-up blocker spyware and anti-phishing protection - along with search tools, customizable

weather features and much more.
The Fan: This interactive, customizable click-and-play feature is packed with news clips, music videos and movie previews.
Comcast Photo Center: Share your photos online, free! Download free software to create scrapbooks, slideshows and more.
Video Mail: Create, preview and send video messages to anyone with an e-mail address. You can even combine digital photos into a movie to send via Video Mail.
Free trials: You'll qualify for amazing deals from Games on Demand and Rhapsody Music.
Plus more to come: We're committed to providing the best online experience available. So we're always working to add new broadband features and special
Web Space:
Get your own online space so you can build a home page that highlights your interests, photos and favorite links. You can also store files online and access them from any computer connected to the Internet.

E-Mail:
Get up to 7 e-mail addresses that can be accessed remotely from any computer. Now everyone in the family can have their own e-mail address! With 250MB of storage per email account, you'll have plenty of space for all your emails.

Digital Voice: Digital Voice:

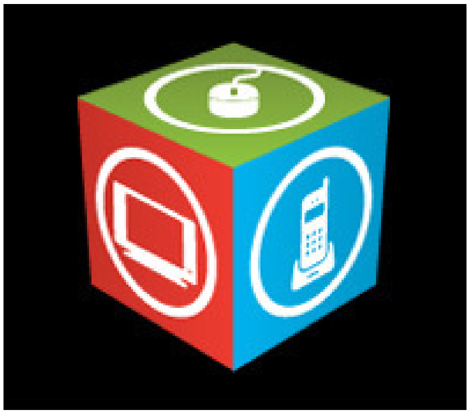
Unlimited local and long-distance calling
Call anyone, anytime, anywhere in the country - all for one low price.
Keep your current phone number
When you switch to Comcast Digital Voice®, bring your phone number with you.
Works with your existing phone
Keep your current touch-tone phone — Comcast Digital Voice® works just like your existing phone.
Service you can depend on
Comcast Digital Voice® and our advanced broadband network ensures that your home phone service is there when you need it.
One bill - Plus online account summary
Enjoy one simple bill for Cable TV, Phone and High-Speed Internet -- plus, you can use your online account summary to view your phone call details.
Popular calling features
...all included in your low monthly price.
a. 3-Way Calling
b. Anonymous Call Rejection
c. Call Forwarding Selective
d. Call Forwarding Variable
e. Call Return
f. Call Screening
g. Call Waiting
h. Caller ID†
i. Caller ID Blocking Per Call
j. Caller ID Blocking Per Line
k. Caller ID with Call Waiting†
l. Repeat Dialing
m. Speed Dial 8
n. PLUS Voice Mail

For more information on Comcast Digital Voice®, visit our Product Section.

Offer expires 3/15/07. Offer only available in participating Comcast systems (and may not be transferred). Offer limited to residential customers who do not currently subscribe and have not during the past 120 days subscribed to both Comcast Digital Voice and Comcast High-Speed Internet services, in wired and serviceable locations. Offer limited to Comcast High-Speed Internet 6.0 Mbps service and Comcast Digital Voice service. Advertised prices are only available with a subscription to both services. If any service is cancelled during the promotional period, Comcast's regular charges apply for any remaining services. **AFTER THE PROMOTIONAL PERIOD, COMCAST'S REGULAR CHARGES APPLY UNLESS SERVICE IS CANCELLED. YOU MAY CANCEL SERVICE BY CALLING 1-800-COMCAST.** Comcast's current regular monthly service charge for both services is $87.90, for customers who do not subscribe to Comcast video service and $82.90 for customers who subscribe to Comcast video service. Savings of approximately $166 based on the difference between promotional rates over regular rates for both services when subscribing to Comcast Video service. Video charges are in addition to stated prices. Service is subject to Comcast standard terms and conditions of service. EMTA from Comcast is required for Comcast Digital Voice service (and may also be used for Comcast High-Speed Internet Service). Comcast's monthly EMTA rental fee of $3 ($5 for home networking) applies and is in addition to advertised prices. Installation fees are additional. $29.95 activation fee applies for Comcast Digital Voice. Prices shown do not include applicable taxes, franchise fees and in the case of Digital Voice, the Regulatory Recovery Fee (which is not a tax) or government required or other applicable charges (e.g., per-call charges). May not be combined with other offers. PowerBoost (only available with Comcast 6.0/8.0 Mbps High Speed Internet service) provides a burst of speed when downloading the first 10 MB of a file with 6.0Mbps service or the first 20MB of a file with 8.0Mbps service. It then reverts to the provisioned speed for the remainder of the download. Stated speeds and comparisons are for downloads only and compare Comcast 6.0 Mbps service to 768 Kbps DSL and 56 Kbps dial-up. Many factors affect speed. Actual speeds will vary and are not guaranteed. Not all features, including McAfee, are compatible with Macintosh systems. Unlimited Digital Voice package pricing only applies to direct-dialed calls from home to locations in the U.S., Canada, Puerto Rico, Guam, the U.S. Virgin Islands and Saipan. No separate long distance carrier connection available. Plan does not include international calls. Comcast Digital Voice Service (including 911/emergencey services) may not function after an extended power outage. Certain customer-premise equipment may not be compatible with Comcast Digital Voice service. For restrictions, minimum requirements, and complete details about services and prices, call 1-800-COMCAST or go to comcast.com.

Triple Play

Close Window



Comcast is now offering internet, phone and cable together in one package for just $33 each per month for one year when you sign up for all three. It's a great value.

This package is designed for new customers and includes:

Comcast Digital Cable with ON DEMAND
Get the best in entertainment with ON DEMAND- a library of tons of free movies and programs that are ready to watch when you are. You'll also get 100% Digital quality picture and sound. Over 100 channels including music, sports and family entertainment. Plus, an interactive on-screen guide, and commercial-free digital music. Dish doesn't offer all this!

- $33 per month for 1 year when you subscribe to all three services.*

Comcast High-Speed Internet
Download music, photos and videos way faster than DSL and Dial up. Plus, get McAfee virus protection, firewall and parental controls.

- $33 per month for 1 year when you subscribe to all three services.*

Comcast Digital Voice®
Enjoy unlimited local and nationwide long distance calls so you can talk as much as you want. Plus, Voice Mail with web access,12 popular calling features like Caller ID, 3-Way Calling and Anonymous Call Blocking. Online account summary and call detail. Keep your number or change it - you decide.

- $33 per month for 1 year when you subscribe to all three services.*
  EMTA required for an additional monthly fee.

Note: Price after 12 month promotional period will vary depending on your area and level of service chosen at that time.

View the Channel Lineup for your area. Select "View By Package" to see what channels you get with our different packages. While you're there, search for your favorite channels or sort by program genres!

The *Triple Play* package you have selected includes the following:

Cable: Comcast Digital Cable package offers you a large variety of popular cable networks and digital music channels, so there is something to watch for everyone in your home.

TV will now be on your schedule with ON DEMAND from Comcast Digital Cable. Pick a show. Play it whenever. Enhanced Cable gives you the power of ON DEMAND, an extensive library of hit shows and movies ready to watch when you are. You can pause, rewind or fast-forward your selected program anytime.

The Interactive Program Guide lets you easily search for programs by time, category or channel. Get instant information on any show and program your TV to remind you when your favorite shows start. Plus, easily block unwanted programs with our Parental Control feature.

Comcast High-Speed Internet:

Content:
Enjoy full access to Comcast.net, our dynamic Internet launching pad that's your starting point for news, e-mail, video mail and much more. (Read more about Comcast.net below.)

Access friendly, experienced customer support 24 hours a day, seven days a week, and tap into a variety of helpful online self-service tools, real-time chat and e-mail. Visit the Service Center often to view answers to frequently asked questions, read the latest virus alerts or change your password. Comcast.net puts tons of information at your fingertips.

You'll have full privileges on Comcast.net, the exclusive portal that gives you instant access to a world of tools, videos, information and fun. Here are just a few of the exciting features on Comcast.net:

- **McAfee Security:** Protect your computer and personal information with top-rated McAfee Virus Protection, Firewall, and parental controls.
- **Rhapsody Radio PLUS:** Create your own commercial-free, customizable radio stations, access over 2 million songs, watch music videos and much more - all free.
- **Comcast Toolbar:** Get free pop-up blocker spyware and anti-phishing protection - along with search tools, customizable weather features and much more.
- **The Fan:** This interactive, customizable click-and-play feature is packed with news clips, music videos and movie previews.
- **Comcast Photo Center:** Share your photos online, free! Download free software to create scrapbooks, slideshows and more.
- **Video Mail:** Create, preview and send video messages to anyone with an e-mail address. You can even combine digital photos into a movie to send via Video Mail.
- **Free trials:** You'll qualify for amazing deals from Games on Demand and Rhapsody Music.
- **Plus more to come:** We're committed to providing the best online experience available. So we're always working to add new broadband features and special

Web Space:
Get your own online space so you can build a home page that highlights your interests, photos and favorite links. You can also store files online and access them from any computer connected to the Internet.

E-Mail:
Get up to 7 e-mail addresses that can be accessed remotely from any computer. Now everyone in the family can have their own e-mail address! With 250MB of storage per email account, you'll have plenty of space for all your emails.

Digital Voice:

- **Unlimited local and long-distance calling**
  Call anyone, anytime, anywhere in the country - all for one low price.
- **Keep your current phone number**
  When you switch to Comcast Digital Voice®, bring your phone number with you.
- **Works with your existing phone**
  Keep your current touch-tone phone — Comcast Digital Voice® works just like your existing phone.
- **Service you can depend on**

Comcast Digital Voice® and our advanced broadband network ensures that your home phone service is there when you need it.

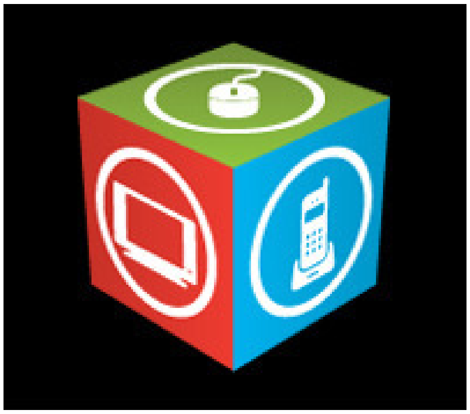
- **One bill - Plus online account summary**
  Enjoy one simple bill for Cable TV, Phone and High-Speed Internet -- plus, you can use your online account summary to view your phone call details.
- **Popular calling features**
  ...all included in your low monthly price.
  a. 3-Way Calling
  b. Anonymous Call Rejection
  c. Call Forwarding Selective
  d. Call Forwarding Variable
  e. Call Return
  f. Call Screening
  g. Call Waiting
  h. Caller ID†
  i. Caller ID Blocking Per Call
  j. Caller ID Blocking Per Line
  k. Caller ID with Call Waiting†
  l. Repeat Dialing
  m. Speed Dial 8
  n. PLUS Voice Mail

For more information on Comcast Digital Voice®, visit our **Product Section**.

Offer ends 3/15/07. Offer only available in participating Comcast systems (and may not be transferred) and is limited to new residential customers, or existing customers who subscribe to Comcast Basic Cable Service only who have not subscribed to any of the three promotional services for the past 120 days, located in Comcast Cable wired and serviceable areas. Offer not available to customer with unpaid Comcast account balances. Offer limited to Comcast Digital Starter, Comcast High-Speed Internet 6.0 Performance Service and Comcast Digital voice service. Advertised prices only available with subscription to all 3 services. If any service is cancelled or downgraded during the promotional period, Comcast's regular charges apply for any remaining services. AFTER THE PROMOTIONAL PERIOD, COMCAST'S REGULAR CHARGES APPLY UNLESS SERVICE IS CANCELLED BY CALLING 1-800-COMCAST. Bundled offer savings currently range from approximately $29.13 to $45.51 monthly (depending on area) over non-promotional rates. Offer good only for service to a single outlet (except for Digital Voice Service). Service is subject to Comcast standard terms and conditions of service. Equipment, including a converter and remote control (for certain cable services, use of one converter included with Digital Starter) a cable modem (for High-Speed Internet service) and EMTA from Comcast (for telephone service and which may also be used for High-Speed Internet service) required. Applicable equipment and installation fees are additional. Prices shown do no include taxes and franchise fees. Not all programming and services available in all areas. May not be combined with other offers. Please call your local Comcast office for restrictions and complete details about service, prices and equipment. **Cable Service:** Certain services are available separately or as part of other levels of service. Basic Service subscription is required to receive other levels of service. ON DEMAND selections subject to charge indicated at the time of purchase. Additional features and services may be purchased at regular service rates. **High-Speed Internet Service:** Speeds stated and comparisons for downloads only and compare Comcast 6.0 Mbps to 768 Kbps DSL and 56 Kbps dial-up. PowerBoostTM only available with Comcast's 6.0/8.0 Mbps speed plans. PowerBoost provides a brief burst of download speed above the customer's provisioned download speed for the first 10MB of a file. It then reverts to the provisioned speed for the remainder of the download. Many factors affect speed. Actual speeds vary and are not guaranteed. Not all features, including McAfee, are compatible with Macintosh systems. **Digital Voice:** Unlimited package pricing applies to all direct-dialed calls to locations in the U.S., Canada and Puerto Rico, from home. No separate long distance carrier connection available. Plan does not include international calls. Comcast Digital Voice service (including 911/emergency service) may not function after an extended power outage. Certain customer premises equipment may not be compatible with Comcast Digital Voice service. Pricing shown does not include the Regulatory Recovery Fee, which is not a tax or government required or other applicable charges (e.g., per – call charges). Caller ID equipment is required. EMTA from Comcast required for an additional monthly fee (current monthly charge of $3, or $5 for Home Networking).

Preferred Plus Bundle

Close Window



Comcast is now offering internet, phone and cable together in one package, plus Digital Preferred Plus w/HBO and Starz - all for just **$129.99/month for 12 months**. It’s a great value. This package is designed for new customers and includes:

Comcast Digital Cable with HBO/Starz and ON DEMAND
Get the best in entertainment with ON DEMAND- a library of tons of free movies and programs that are ready to watch when you are. You’ll also get 100% Digital quality picture and sound. Over 100 channels including music, sports and family entertainment. Plus, an interactive on-screen guide, and commercial-free digital music. Dish doesn't offer all this!

Comcast High-Speed Internet
Download music, photos and videos way faster than DSL and Dial up. Plus, get McAfee virus protection, firewall and parental controls.

Comcast Digital Voice®
Enjoy unlimited local and nationwide long distance calls so you can talk as much as you want. Plus, Voice Mail with web access,12 popular calling features like Caller ID, 3-Way Calling and Anonymous Call Blocking. Online account summary and call detail. Keep your number or change it - you decide.

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Note: Price after 12 month promotional period varies based on your area and level of service chosen at that time.
Cable: Comcast Digital Cable package offers you a large variety of popular cable networks and digital music channels, so there is something to watch for everyone in your home.

TV will now be on your schedule with ON DEMAND from Comcast Digital Cable. Pick a show. Play it whenever. Enhanced Cable gives you the power of ON DEMAND, an extensive library of hit shows and movies ready to watch when you are. You can pause, rewind or fast-forward your selected program anytime.

The Interactive Program Guide lets you easily search for programs by time, category or channel. Get instant information on any show and program your TV to remind you when your favorite shows start. Plus, easily block unwanted programs with our Parental Control feature.

Comcast High-Speed Internet:

Content:
Enjoy full access to Comcast.net, our dynamic Internet launching pad that’s your starting point for news, e-mail, video mail and much more. (Read more about Comcast.net below.)

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The Fan: This interactive, customizable click-and-play feature is packed with news clips, music videos and movie previews.

Comcast Photo Center: Share your photos online, free! Download free software to create scrapbooks, slideshows and more.

Video Mail: Create, preview and send video messages to anyone with an e-mail address. You can even combine digital photos into a movie to send via Video Mail.
Free trials: You'll qualify for amazing deals from Games on Demand and Rhapsody Music. Plus more to come: We're committed to providing the best online experience available. So we're always working to add new broadband features and special

Web Space: Get your own online space so you can build a home page that highlights your interests, photos and favorite links. You can also store files online and access them from any computer connected to the Internet.

E-Mail: Get up to 7 e-mail addresses that can be accessed remotely from any computer. Now everyone in the family can have their own e-mail address! With 250MB of storage per email account, you'll have plenty of space for all your emails.

Comcast Digital Voice:

Unlimited local and long-distance calling
Call anyone, anytime, anywhere in the country - all for one low price.

Keep your current phone number
When you switch to Comcast Digital Voice®, bring your phone number with you.

Works with your existing phone
Keep your current touch-tone phone — Comcast Digital Voice® works just like your existing phone.

Service you can depend on
Comcast Digital Voice® and our advanced broadband network ensures that your home phone service is there when you need it.

One bill - Plus online account summary
Enjoy one simple bill for Cable TV, Phone and High-Speed Internet -- plus, you can use your online account summary to view your phone call details.
Popular calling features
...all included in your low monthly price.

a. 3-Way Calling
b. Anonymous Call Rejection
c. Call Forwarding Selective
d. Call Forwarding Variable
e. Call Return
f. Call Screening
g. Call Waiting
h. Caller ID†
i. Caller ID Blocking Per Call
j. Caller ID Blocking Per Line
k. Caller ID with Call Waiting†
l. Repeat Dialing
m. Speed Dial 8
n. PLUS Voice Mail

For more information on Comcast Digital Voice®, visit our Product Section.

Offer ends 3/15/07. Offer only available in participating Comcast systems (and may not be transferred) and is limited to new customers or existing customers who: i) only subscribe at Comcast's regular (non-promotional) rate to 1 or 2 of the following Comcast services: Cable, High-Speed Internet Access, and Digital Voice or Digital Phone service and ii) customers currently subscribing to two of those services under Comcast's $69 promotion or three of those services under Comcast's $99 promotion (customers who have previously subscribed to any of these services under a $69/$99 promotion which has ended are not eligible). Except for the $69/$99 promotions, offer is not available to customers who have subscribed to any Comcast service at a promotional rate during the past 120 days and offer is not available to customers who have subscribed to all three services during the past 120 days. Offer not available to customers with unpaid Comcast account balances. Offer limited to Comcast Digital Preferred Plus with HBO & STARZ (premiums may not be substituted with other premiums), 6.0 Mbps High-Speed Internet access and Comcast Digital Voice service. Advertised prices only available with subscription to all 3 services. If any service is cancelled or downgraded during the promotional period, Comcast's regular charges apply for any remaining services. AFTER THE PROMOTIONAL PERIOD, COMCAST'S REGULAR CHARGES APPLY UNLESS SERVICE IS CANCELLED BY CALLING 1-800-COMCAST. Bundled offer savings range from approximately $36.61 to $44.51 monthly (depending on area) over non-promotional rates as of rate card pricing listed 12/15/06. Comcast Digital Preferred Plus with HBO and STARZ and High Speed Internet access offer limited to service to a single outlet. Service is subject to Comcast standard terms and conditions of service. Programming is subject to change. Equipment, including a converter and remote control for certain cable services (use of one converter and remote is included under offer), a cable modem (for High-Speed service) and EMTA from Comcast (for telephone service and which may also be used for Comcast High Speed service) required. Applicable equipment and installation fees are additional. Prices shown do not include taxes and franchise fees or in the case of Comcast Digital Voice, the Regulatory Recovery Fee, which is not a tax or government required or other applicable charges (e.g., per-call charges). $29.95 activation fee applies to new Comcast Digital Voice service. Not all programming and services available in all areas. May not be combined with other offers. Please call your local Comcast office for restrictions and complete details about service, prices and equipment. All other trademarks are the property of their respective owners. HBO®, HBO on Demand®, The Sopranos®, EntourageSM and Big LoveSM are service marks of Home Box Office Inc. STARZ and STARZ On Demand are service marks of Starz Entertainment Group. Cable Service: Certain services are available separately or as a part of other levels of service. Basic Service subscription is required to receive other levels of service. ON DEMAND selections subject to charge indicated at the time of purchase. Additional features and services may be purchased at regular service rates. High-Speed Service: Speeds stated and comparisons for downloads only and compare Comcast 6.0 Mbps to 768 Kbps DSL and 56 Kbps dial-up. PowerBoost provides a brief burst of download speed above the customer's provisioned download speed for the first 10MB of a file. It then reverts to the provisioned speed for the remainder of the download. Many factors affect speed. Actual speeds vary and are not guaranteed. Not all features, including McAfee, are compatible with Macintosh systems. Comcast Digital Voice: Unlimited package pricing applies to all direct-dialed calls to locations in the U.S., Canada and Puerto Rico, from home. No separate long distance carrier connection available. Plan does not include international calls. Comcast Digital Voice service (including 911/emergency services) may not function after an extended power outage. Certain customer premises equipment may not be compatible with Comcast Digital Voice service. Caller ID equipment is required. EMTA from Comcast required for an additional monthly charge (current monthly charge of $3, or $5 for Home Networking).

Appendix 2

Verizon Communications, Inc.

Nationwide Operations

At the end of the third quarter of 2006, Verizon served 45,973,000 switched access lines consisting of 28,523,000 residential lines, 17,095,000 business lines, and 355,000 public (pay telephone) lines. In addition, Verizon served over 3.6 million wholesale lines, and 6.5 million broadband customers.[1] Verizon also served 7.5 million Freedom package, 522,000 FiOS Internet, and 118,000 FiOS TV subscribers.[2]

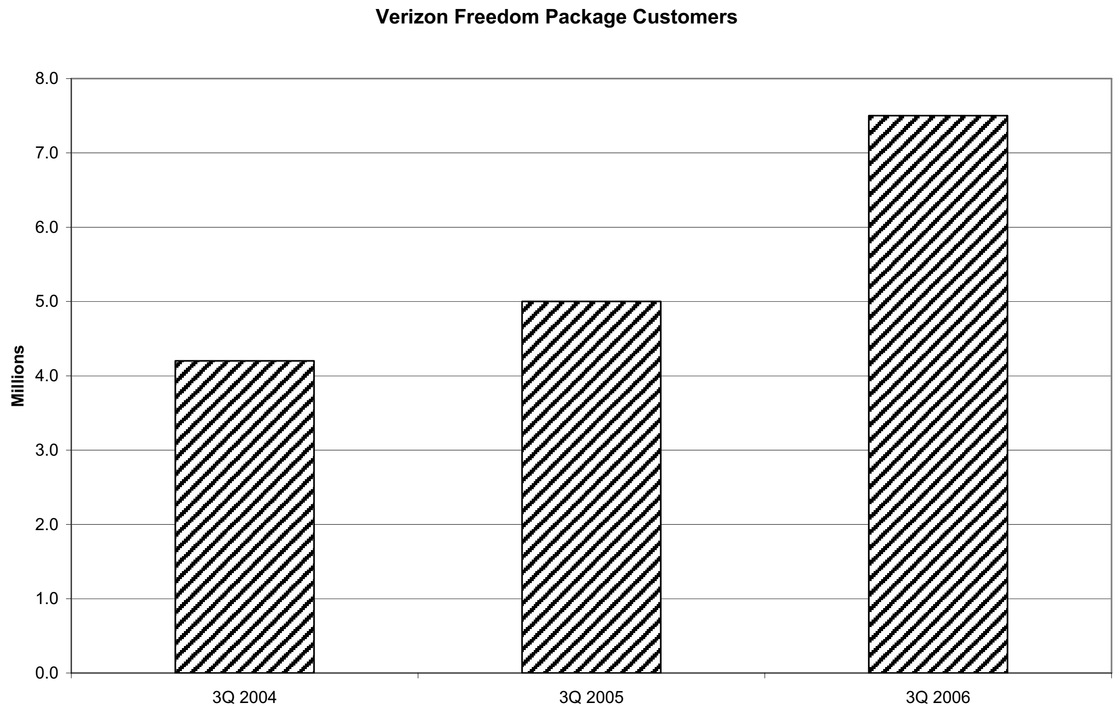
Verizon Nationwide Subscription Data as of September 30, 2006

Total Switched Access Lines	45,973,000
Residence	28,523,000
Business	17,095,000
Public	355,000
Wholesale Voice Connections	3,621,000
Broadband Connections	6,573,000
Verizon Freedom Packages	7,500,000
FiOS Internet Customers	522,000
FiOS TV Customers	118,000

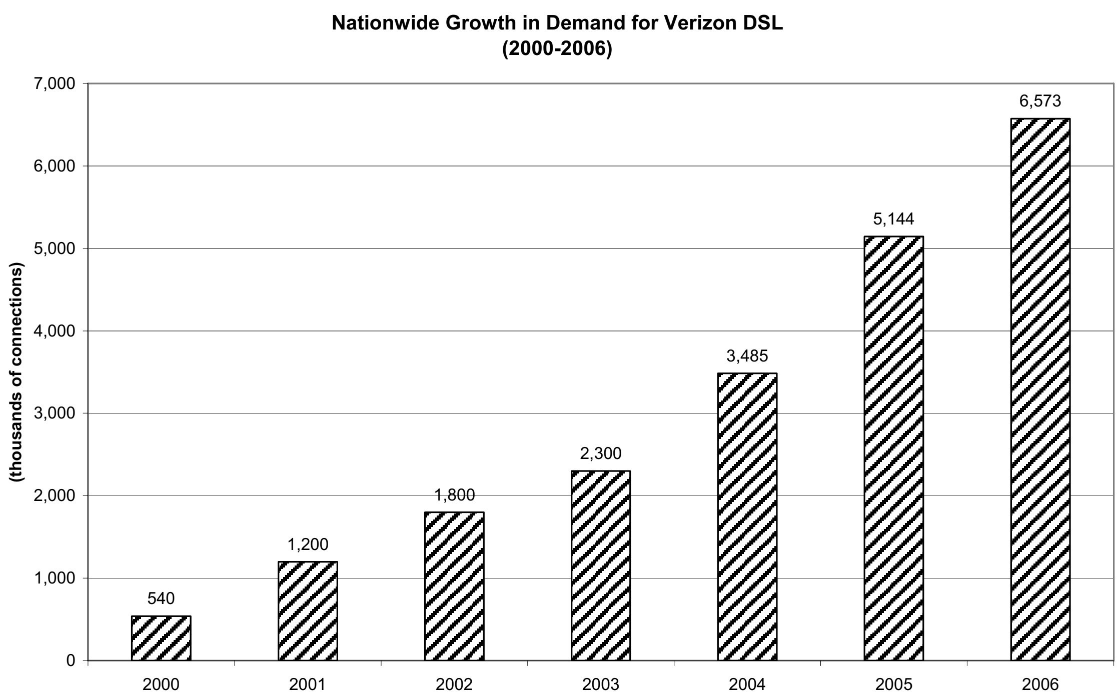
Source: Verizon Communications Inc., *3Q 2006 Investor Quarterly*, October 30, 2006.

[1] / Verizon Communication, Inc., *Q3 2006 Investor Quarterly*, October 30, 2006 ("Verizon Q3 2006 Investor Quarterly"), page 14.

[2] / *Id.,* pages 3 and 6.



Sources: Verizon *Investor Quarterly* , Q3 2004,Q3 2005, and Q3 2006.



Note: Figures are for year end, except for 2006, which is Q3. Sources: Verizon Q4 2000 Investor Quarterly, page 5; Verizon Q4 2002 Investor Quarterly, page 5; Verizon 2005 Annual Report, page 13; Verizon Q3 2006 Investor Quarterly, page 2.

Verizon FiOS

FiOS is Verizon's marketing name for its deployment of fiber optics to customers' premises. In addition to upgrading equipment and running new fiber optic connections to subscribers, FiOS involves marketing new services such as FiOS Internet service and FiOS TV.

The Verizon website describes fiber-to-the-premises and its advantages:

> Fiber to the Premises (FTTP) refers to Verizon's network upgrade that will utilize fiber-optic cables and associated optical electronics instead of copper wire to connect a customer to the Verizon network. Fiber-optic systems have been used in telecom networks for years, but primarily in the long-haul or inter-city portions, as well as directly connecting some large-business customers that have heavy data transfer needs. [3]

Verizon's description continues:

> FTTP has the following advantages:
>
> > Fiber technology provides nearly unlimited bandwidth, as much as 20 times faster than today's fastest high-speed data connections.
> > FTTP provides more reliable service that is less susceptible to inclement weather and easier to maintain. Verizon can monitor the performance of the network and make repairs prior to customers noticing problems.
> > The new technology enables a wide variety of uses, from interactive content and home shopping to telecommuting to telemedicine and audio/video on demand.
> > FTTP is easier to maintain and extremely flexible to customer preference – new products and services can be activated remotely, either permanently or on demand.
> > FTTP provides a "blank canvas" for technology innovators at Verizon and elsewhere to create the tools and uses of FTTP for the burgeoning broadband economy. [4]

Rollout:

Verizon began rollout of the fiber network in 2004. As of the end of the third quarter 2006, Verizon's FTTP passed a total of 5.3 million homes.[5] In a conference with

[3] / http://www.verizonnj.com/fttp/NJ/Verizon_FTTP_Technology.asp.

[4] / *Id.*

industry analysts, a Verizon executive remarked, "We will meet our 6 million [homes passed] objective by the end of the year. We will open 5 million premises for sale on the data side… You can see the end-of-period [year 2010] objective there -- 18 million homes passed. And also, that would be about 50% of our households."[6]

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[5] / *Verizon Q3 2006 Investor Quarterly* , at page 3.

[6] / Thomson StreetEvents, Conference Call Transcript, Verizon FiOS Briefing Session, Sept. 27, 2006 ("FiOS Briefing Session"), at page 4.

Recent FiOS Rollout Announcements

Date	Location	Details
Dec. 4, 2006	Greater Philadelphia Area	"In southeastern Pennsylvania, Verizon FiOS TV is available now to 80,000 households in parts of 35 communities in Bucks, Chester, Delaware and Montgomery counties. The company expects that number to increase to 100,000 households by the end of the year. In Delaware, Verizon plans to offer FiOS TV to 13,000 households in the southern New Castle County area by the end of the year."
Dec. 12, 2006	Annapolis, MD	"Verizon will offer the city's 18,000 households its FiOS TV product… Annapolis joins the cities of Laurel and Bowie, and Anne Arundel, Howard, Montgomery and Prince George's counties, in endorsing consumer choice and competition, bringing to more than 900,000 the number of Maryland households in areas where Verizon has local franchises to offer television service."
Dec. 12, 2006	Lynn, Marblehead, and Needham, MA	"Verizon has introduced FiOS TV to consumers in Lynn, Marlborough and Needham, adding 40,000 more households to its growing list of communities where its revolutionary service is available. FiOS TV is now available to more than 177,000 households in the Bay State."
Dec. 12, 2006	Littleton and Georgetown, MA	Provides Verizon access to "nearly 6,000 more Massachusetts households. [This] brings to 35 the total number of Massachusetts communities where Verizon's FiOS TV is or will soon be available."
Jan. 11, 2007	New Jersey	"In New Jersey, Verizon's FiOS TV is available now to approximately 250,000 households in parts of 106 communities in Bergen, Camden, Middlesex, Monmouth, Morris, Passaic, Somerset and Union counties. The service will soon be expanded to hundreds of thousands of additional households in more than 100 additional communities."

Source: Verizon press releases of December 4, 2006, December 12, 2006, and January 11, 2007.

Current Penetration Rates and Future Goals:

As of the end of the third quarter 2006, Verizon's FTTP passed a total of 5.3 million homes, with penetration of FiOS Internet service at 14% over all markets. FiOS

TV service reached 10% penetration over all markets.[7] FiOS Internet customers totaled 522,000 at the end of the third quarter 2006 and FiOS TV customers totaled 118,000.[8] Verizon executives set a target of enrolling 175,000 FiOS TV subscribers by the end of 2006.[9]

Verizon's current penetration rate goal is 15% after one year of marketing FiOS services to a given area, and by 2010, Verizon expects a 35-40% penetration rate for data services, and 25% for video services.[10] Through FiOS, Verizon expects to retain 40-50% of the voice lines that it anticipates otherwise would have been lost to competition.[11] According to Verizon, 70% of FiOS Internet subscribers are new to Verizon broadband.

FiOS as a Bundle:

FiOS is an important part of Verizon's growth strategy in part due to its effectiveness in retaining customers, but also in encouraging customers to buy more services. By fall 2006, 99% of FiOS TV customers were purchasing at least two services; 79% of FIOS TV customers were subscribing to three services.[12] Verizon reports that, "[c]hurn among FiOS customers remains lower than 1.5 percent per month, and cost associated with customer churn continue to be lower than anticipated."[13]

Video:

Verizon began offering FiOS-based video service in three markets in 2005. Keller, Texas, the first FiOS video service market, reached a video penetration rate of 21% after only four months.[14] By December 2006, Verizon had acquired franchises in more than 230 areas in ten states, covering approximately 5 million households.[15] This does not include the statewide franchise recently award to Verizon in New Jersey. According to Verizon, approximately two-thirds of FiOS TV customers are former cable customers.[16]

Profitability/Returns:

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[7] / *Verizon Q3 2006 Investor Quarterly*, at page 5.

[8] / *Id.*, at page 3.

[9] / *FiOS Briefing Session*, at page 4.

[10] / *Id.*, at page 11.

[11] / *Id.*, at page 23.

[12] / *Id.*, at page 5.

[13] / *Verizon Q3 2006 Investor Quarterly*, at page 5.

[14] / Verizon 2005 Annual Report, at page 15.

[15] / Verizon News Release "TV as You've Never Seen It Before: Verizon Launches FiOS TV in Greater Philadelphia Area," December 4, 2006.

[16] / *FiOS Briefing Session*, at page 5.

Although it is still early in the rollout of FiOS services, Verizon anticipates that FiOS will become a profitable business segment. One Verizon executive remarked, "[w]e believe FiOS will result in sustainable profit growth for the business for years to come."[17] Verizon reported to industry analysts that it expects FiOS to reach positive EBITDA in its third year and positive operating income in its fourth year.[18]

Regarding the prospects for FiOS TV, a Verizon executive stated:

> When we look at the Verizon footprint, we know that there is about a $50 billion market for us, and about $20 billion of that is new revenue to us. It is in the form of video revenue. So we see this as a great opportunity for us to really grow revenue, grow profitable revenue.[19]

Presently, however, in the third quarter of 2006, income dilution from FiOS data and video deployment was 9 cents per share. Verizon increased the full year estimate for this dilution from 28-to-30 cents per share to 31-to-32 cents per share.[20] There were approximately 2.9 billion shares at the end of Q3 2006[21], which means the earnings dilution for 2006 is approximately $900 million.

Rollout Costs:

Verizon expects FiOS deployment to cost about $22.9 billion over seven years. Verizon calculates that, on a per-home basis, this breaks down to an average $817 cost to pass consisting of $172 for the video network and $718 to connect. Verizon has indicated that the FTTP effort will allow it to avoid spending $5 billion running copper to greenfields, thereby effectively reduces the total cost of fiber deployment to about $1,400 per home passed, or $2,500 per connected home.[22]

The following table details Verizon's goals for reducing costs to run fiber and connect homes.

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[17] / *Id.*, at page 3.

[18] / *Id.*, at page 25.

[19] / *Id.*, at page 3.

[20] / *Verizon Q3 2006 Investor Quarterly*, at page 5.

[21] / *Id.*, at page 7.

[22] / *FiOS Briefing Session*, at page 24. (Estimates of savings from deploying fiber are from Verizon.)

Evolution of FiOS Rollout Costs

	Cost To Pass	Cost To Connect
December 2005 (actual)	$1,021	$1,200
September 2006 (actual)	$845	$900
2010 (goal)	$700	$880

Sources: Thomson StreetEvents, Conference Call Transcript, Verizon FiOS Briefing Session, Sept. 27, 2006; Verizon *Investor Quarterly*, Third Quarter 2006, October 30, 2006, at page 5.

Prices for Consumers:

The Verizon website lists the benefits, features, and pricing of FiOS Internet service:

> Introducing Verizon FiOS Internet Service. It's the next generation in broadband. Verizon FiOS (FYE'-ose) is the new suite of fiber-optic services over FTTP, an advanced fiber-optic technology that can be used to connect a home or business directly to Verizon's network. Fiberoptic systems use strands of glass fiber and laser-generated pulses of light to transmit voice, data and video signals at speeds and capacities far exceeding today's systems. This new network will have greater reliability and lower maintenance costs. By deploying fiber to homes and businesses in our territory, Verizon is reinventing its wireline business.
>
> FiOS service consists of three consumer broadband speeds: up to 5 Mbps downstream and up to 2 Mbps upstream (5 Mbps/2 Mbps), 15 Mbps/2 Mbps and 30 Mbps/5 Mbps.
>
> Verizon FiOS enables customers to do more with the Internet than ever before, such as download purchased digital movies in a flash, play online games at lightning speeds, share large photo files, and video chat with friends and family. Work-at-home customers will enjoy speeds comparable to their office environment.
>
> With FiOS, Verizon offers superior broadband speeds at very competitive prices along with Verizon's existing wireline and wireless, local and long-distance telephony services – and, eventually, new video services.

Pricing for FiOS

5 Mbps/2 Mbps for $34.95 a month as part of a calling package, or $39.95 a month stand-alone
15 Mbps/2 Mbps for $44.95 a month as part of a calling package, or $49.95 a month stand-alone
30 Mbps/5 Mbps for $179.95 a month as part of a calling package, or $199.95 a month stand-alone

All FiOS Internet Service packages include:
Free installation by Verizon professionals
Ultra high-speed Internet access
Free networking router
MSN™ Premium Internet Software – a $99 annual value
24/7 live technical support
Up to nine verizon.net e-mail accounts
Access to newsgroups
Personal Web space of 10 MB

Verizon press releases offer details about pricing for markets recently added to the FiOS TV network. Excerpts from Verizon's press releases for selected cities follow:

Philadelphia Area:
Verizon's FiOS TV Premier package delivers 200 all-digital channels for $42.99 per month. The package includes more than 20 high definition (HD) channels in the Philadelphia market and access to approximately 4,000 on-demand titles, 60 percent of which are free. Sports fans subscribing to FiOS TV Premier in the Philadelphia market will also receive SportsNet Philadelphia at no extra charge. Verizon offers three set-top boxes: standard definition for $4.99 per month; high definition, which includes HD channels, for $9.99 per month; and a dual-tuner, HD-capable digital video recorder for $12.99 per month.[23]

Massachusetts:
Massachusetts residents who are FiOS TV-eligible now have the option to trim their monthly bills by bundling FiOS TV service, FiOS Internet Service and the Verizon Freedom Value unlimited calling plan, all for $104.85.[24]

[23] / Verizon News Release "TV as You've Never Seen It Before: Verizon Launches FiOS TV in Greater Philadelphia Area," December 4, 2006.

[24] / Verizon News Release, "Verizon FiOS TV Comes to Lynn, Marlborough and Needham, Mass.," December 12, 2006.

New Jersey:
Verizon's FiOS TV Premier package delivers 200 all-digital channels for $42.99 per month. The package includes more than 20 high-definition (HD) channels in the New Jersey market and access to more than 4,000 on-demand titles, 60 percent of which are free.

Verizon offers three set-top boxes: standard definition for $4.99 per month; high definition, which includes HD channels, for $9.99 per month; and a dual-tuner, HD-capable digital video recorder for $12.99 per month.

Verizon also offers innovative features not available from other providers, such as Home Media DVR (digital video recorder) and FiOS TV Widgets. Home Media DVR, at $19.99 per month, has a multiroom DVR feature enabling up to three simultaneous viewings of recorded programs without requiring customers to set up a complex home network or buy extra equipment. Customers also can access photos and music on their PCs and play them on their TVs.[25]

[25]/ Verizon News Release, "TV as You've Never Seen It Before: Verizon Launches FiOS TV in 106 New Jersey Communities," January 11, 2007.

A Selection of Verizon Calling Plans and Bundles

Verizon Local Package - $23.95
- Unlimited direct-dialed local calling
- Unlimited local directory assistance
- Your choice of up to three popular calling features

Verizon Local Package Extra - $27.95
- Unlimited direct-dialed local calling
- Unlimited local directory assistance
- Your choice of 10 or more popular calling features

Verizon Freedom Value - $34.99
- Unlimited local, regional toll and long distance* calling in the U.S. and Puerto Rico

Verizon Freedom Essential - $44.99
- Unlimited local, regional toll and long distance* calling in the U.S. and Puerto Rico
- Our three popular calling features: Home Voice Mail, Caller ID, Call Waiting

Verizon Freedom - $57.99
- Unlimited local, regional toll and long distance* calling in the U. S., Canada and Puerto Rico
- Five popular calling features - Home Voice Mail, Caller ID, Call Waiting, Speed Dialing and Three-Way Calling
- Discounts on international calls

Verizon Freedom Extra - $62.99
- Unlimited local, regional toll and long distance* calling in the U.S., Canada and Puerto Rico
- Choice of more than 10 calling features including Call Intercept, Home Voice Mail, Caller ID, Call Waiting and Speed Dialing
- Discounts on international calls
- Unlimited local directory assistance

Verizon FiOS TV and DIRECTV – prices vary

Verizon Local Package

Get your local calling along with your choice of three popular calling features.

Verizon Local Package groups local calling, local directory assistance and your **choice of three** popular calling features in one convenient package. Need to make regional or long distance calls? See our Regional & Long Distance Savings tabs for special rates available to Verizon Local Package customers.

Service Location

New Jersey
Change location

Product Recommender

Find products and services that best meet your needs.
Get started

Resources

- Product Instructions
- Calls covered by this plan

Monthly Fee: $23.95 add to cart

Regional Savings | Long Distance Savings

Verizon Local Package includes:

- **Unlimited** direct-dialed local calling
- **Unlimited** local directory assistance
- **Your choice of up to three** popular calling features
- **Single bill** for all services
- **Fixed** monthly rate

back add to cart

There is no one-time charge to establish Verizon Local Package. There may be a premise visit charge for installation, should it be required. You can change your service elections at any time, without any service fees. There may be additional usage charges for some of the features. Certain call types may also be excluded.

*The regional toll Verizon Five Cents Plan is provided by Verizon. To qualify and/or remain eligible for the Verizon Five Cents Plan, you must select a qualifying Verizon local package and retain Verizon as your regional toll provider. If the qualifying local package is removed from your line, then the Verizon Five Cents Plan will also be removed and your regional toll calls may be rated at the basic regional toll rates unless another qualifying plan is selected.

Timeless and Verizon 5 Cent Package Plans are provided by Verizon Long Distance. You must select a qualifying Verizon local package and retain Verizon Long Distance in order to receive these special rates. If the qualifying local package is removed from your line, then you must select another long distance plan or be defaulted to another plan. If you had Timeless, you will be defaulted to **TalkTime 30 where state-to-state rates are 10¢ per minute and a monthly fee applies. If you had Verizon 5 Cent Package Plan, you will be defaulted to **Verizon Five Cents Plan^{sm}** where state-to-state rates are 5¢ per minute and a higher monthly fee applies. Billing name and address must be the same for both Verizon accounts; all charges will appear on the same bill. Universal Service Fees, taxes and other charges apply. Available only to residential customers; may not be available in all areas or on all lines. Rates may be subject to change. Long distance services are subject to service agreements and tariffs, where applicable.

Verizon Local Package Extra

Get your local calling along with your choice of 10 or more popular calling features.

Verizon Local Package Extra groups local calling, local directory assistance and your choice of **10 or more** popular calling features in one convenient package. Need to make regional or long distance calls? See our Regional & Long Distance Savings tabs for special rates available to Verizon Local Package Extra customers.

Service Location

New Jersey
Change location

Product Recommender

Find products and services that best meet your needs.
Get started

Resources

- Product Instructions
- Calls covered by this plan

Monthly Fee: $27.95 add to cart

Regional Savings | Long Distance Savings

Verizon Local Package Extra includes:

- **Unlimited** direct-dialed local calling
- **Unlimited** local directory assistance
- **Your choice of 10 or more** popular calling features
- **Single bill** for all services
- **Fixed** monthly rate

back | add to cart

There is no one-time charge to establish Verizon Local Package Extra. There may be a premise visit charge for installation, should it be required. You can change your service elections at any time, without any service fees. There may be additional usage charges for some of the features. Certain call types may also be excluded.

*The regional toll Verizon Five Cents Plan is provided by Verizon. To qualify and/or remain eligible for the Verizon Five Cents Plan, you must select a qualifying Verizon local package and retain Verizon as your regional toll provider. If the qualifying local package is removed from your line, then the Verizon Five Cents Plan will also be removed and your regional toll calls may be rated at the basic regional toll rates unless another qualifying plan is selected.

Timeless and Verizon 5 Cent Package Plans are provided by Verizon Long Distance. You must select a qualifying Verizon local package and retain Verizon Long Distance in order to receive these special rates. If the qualifying local package is removed from your line, then you must select another long distance plan or be defaulted to another plan. If you had Timeless, you will be defaulted to **TalkTime 30 where state-to-state rates are 10¢ per minute and a monthly fee applies. If you had Verizon 5 Cent Package Plan, you will be defaulted to **Verizon Five Cents Plan**sm where state-to-state rates are 5¢ per minute and a higher monthly fee applies. Billing name and address must be the same for both Verizon accounts; all charges will appear on the same bill. Universal Service Fees, taxes and other charges apply. Available only to residential customers; may not be available in all areas or on all lines. Rates may be subject to change. Long distance services are subject to service agreements and tariffs, where applicable.

Verizon Freedom Value

It's about conversation. Get unlimited local and nationwide long distance-without the bells and whistles, but with all the value.

You don't need extra features. So why pay for them? Verizon Freedom Value^{sm} gives you unlimited local and nationwide long distance calling, and a great rate. Need high-speed Internet or digital-quality TV Entertainment? No problem. See Available Add-ons below. There's a reason we call it Verizon Freedom Value.

Service Location

New Jersey

Change location

Product Recommender

Find products and services that best meet your needs.

Get started

Monthly Fee: $34.99

add to cart

Available Add-ons | Save Even More

Verizon Freedom Value includes :

- **Unlimited** local, regional toll and long distance* calling in the U.S. and Puerto Rico
- **Single bill** for all services
- **Fixed** monthly rate

back | add to cart

*The Verizon Freedom Value Plan is for residential voice use and may not be used for commerical purposes. Verizon may suspend, restrict or cancel your service if your usage is inconsistent with residential voice usage.

You must select and retain Verizon as your local provider, and Verizon Long Distance for long distance service. Plan includes domestic direct-dialed calls only. Cannot be combined with other discounts or promotions. Long distance is provided by Verizon Long Distance and DSL and FiOS service is provided by Verizon Online. Billing name and address must be the same for all your Verizon accounts; all charges will appear on the same bill. Customers must be authorized to make account changes to all accounts. Account must be current at enrollment and have a good payment history. Customers with a security deposit, credit limit, non-basic block or toll block are not eligible. Universal Service Fund, taxes and other charges apply. Tariffs apply to some services. Offer is only for residential customers and for residential use. Available only to residential customers in selected areas. Not all services available on all lines. Additional terms and conditions apply.

Verizon Freedom Essentials

Talk all you want with unlimited local and long distance, accented by our most popular calling features.

No more need to cut long stories short. Verizon Freedom Essentials^{sm} lets you save by combining unlimited local, nationwide long distance, and our three most popular calling features into a phone service worth calling home about. Need high-speed Internet or digital-quality TV Entertainment? No problem. See Available Add-ons below. It's great when you're connected.

Service Location

New Jersey
Change location

Product Recommender

Find products and services that best meet your needs.
Get started

Resources

- Product Instructions

Monthly Fee: $44.99 (In Cart)

Available Add-ons | Save Even More

Verizon Freedom Essentials includes :

- **Unlimited** local, regional toll and long distance* calling in the U.S. and Puerto Rico
- **Our three popular calling features:**
  - Home Voice Mail
  - Caller ID
  - Call Waiting
- **Single bill** for all services
- **Fixed** monthly rate

back (In Cart)

*The Verizon Freedom Essentials Plan is for residential voice use and may not be used for commerical purposes. Verizon may suspend, restrict or cancel your service if your usage is inconsistent with residential voice usage.

You must select and retain Verizon as your local provider, and Verizon Long Distance for long distance service. Plan includes domestic direct-dialed calls. Cannot be combined with other discounts or promotions. Long distance is provided by Verizon Long Distance and DSL and FiOS service is provided by Verizon Online. Billing name and address must be the same for both of your Verizon accounts; all charges will appear on the same bill. Customers must be authorized to make account changes to all accounts. Customers with a security deposit, credit limit, non-basic block or toll block are not eligible. Universal Service Fund, taxes and other charges apply. Tariffs apply to some services. Available only to residential customers in selected areas. Not all services available on all lines. Additional terms and conditions apply.

Verizon Freedom

Bundle your basic Verizon phone services and save.

With Verizon Freedom^{sm}, you'll get your local, regional and long distance services in one convenient package with a single monthly bill. Not to mention five popular calling features. Need high-speed Internet or digital-quality TV Entertainment? No problem. See our available add-ons below.

Service Location

New Jersey
Change location

Give your home a tech-lift

We offer Internet, TV, Phone and Call Management.
See what's available

Resources

Product Instructions

Monthly Fee: $57.99 add to cart

Available Add-ons **Money-Saving Tips**

Verizon Freedom includes:

- **Unlimited** local, regional toll and long distance* calling in the U. S., Canada and Puerto Rico
- **Five** popular calling features - Home Voice Mail, Caller ID, Call Waiting, Speed Dialing and Three-Way Calling
- **Discounts** on international calls
- **Single** bill for all services
- **Fixed** monthly rate

back add to cart

*The Verizon Freedom Plan is for residential voice use and may not be used for commerical purposes. Verizon may suspend, restrict or cancel your service if your usage is inconsistent with residential voice usage.

You must select and retain Verizon as your local provider, and Verizon Long Distance for long distance service. Plan includes domestic direct-dialed calls and calls to Canada and Puerto Rico. Cannot be combined with other discounts or promotions. Billing name and address must be the same for both of your Verizon accounts; all charges will appear on the same bill. Customers must be authorized to make account changes to all accounts. Customers with a security deposit, credit limit, non-basic block or toll block are not eligible. Universal Service Fund, taxes and other charges apply. Tariffs apply to some services. Available only to residential customers in selected areas. Not all services available on all lines. Additional terms and conditions apply.

Verizon Freedom Extra

Get your Verizon Freedom Extra package with your choice of calling features.

Verizon Freedom Extrasm gives you the same services as Verizon Freedom but with your choice of more than 10 calling features. You'll also get unlimited local directory assistance. Need high-speed Internet or digital-quality TV Entertainment? No problem. See our available add-ons below.

Service Location

New Jersey
Change location

Give your home a tech-lift

We offer Internet, TV, Phone and Call Management.
See what's available

Resources

Product Instructions

Monthly Fee: $62.99 add to cart

Available Add-ons | Money -Saving Tips

Verizon Freedom Extra includes:

- **Unlimited** local, regional toll and long distance* calling in the U.S., Canada and Puerto Rico
- **Choice** of more than 10 calling features including Call Intercept, Home Voice Mail, Caller ID, Call Waiting and Speed Dialing
- **Discounts** on international calls
- **Unlimited** local directory assistance
- **One Bill** for all services
- **Fixed** monthly rate

back add to cart

*The Verizon Freedom Extra Plan is for residential voice use and may not be used for commerical purposes. Verizon may suspend, restrict or cancel your service if your usage is inconsistent with residential voice usage.

You must select and retain Verizon as your local service provider, and Verizon Long Distance for long distance service. Plan includes domestic direct-dialed calls and calls to Canada and Puerto Rico. Cannot be combined with other discounts or promotions. Billing name and address must be the same for both of your Verizon accounts; all charges will appear on the same bill. Customers must be authorized to make account changes to all accounts. Customers with a security deposit, credit limit, non-basic block or toll block are not eligible. Universal Service Fund taxes and other charges apply. Tariffs apply to some services. Not all services available in all areas or on all lines. Additional terms and conditions apply.

TV Entertainment

Verizon offers the best programming available with FiOS TV or DIRECTV® service at a price you won't believe. If you wish to see which TV entertainment service is available in your neighborhood before you checkout, go to Change location at the top of the page and enter your Verizon phone number. You must have Verizon phone service to qualify.

Service Location

New Jersey
Change location

Product Recommender

Find products and services that best meet your needs.
Get started

Monthly Fee: Prices Vary

add to cart

Features **Special Offers**

Verizon brings you the latest in TV entertainment with digital programming, ultra-clear picture and sound, state-of-the-art technology and a variety of HD channels. No matter where you are or what you enjoy watching, we have you covered. You'll get:

- Simple to choose packages
- Variety of channels for the entire family
- Superior picture and sound
- Package prices you can't go wrong with
- Single bill for all services

We will determine if FiOS TV or DIRECTV® service is available in your neighborhood once you proceed to checkout. If you wish to see which TV entertainment service is available in your neighborhood before you checkout, go to Change location at the top of the page. If you already have Verizon phone service, please enter your Verizon phone number. You must have Verizon phone service to qualify.

back add to cart

*Free installation is for standard installation on existing TV outlets.

Verizon Freedom: You must select and retain Verizon as your local service provider, and Verizon Long Distance for long distance service. Plan includes domestic direct-dialed calls only. Cannot be combined with other discounts or promotions. Billing name and address must be the same for both of your Verizon accounts; all charges will appear on the same bill. Customers must be authorized to make account changes to all accounts. Universal Service Fees, taxes and other charges apply. Tariffs apply to some service. Available only to residential customers in selected areas. Not all services available on all lines. Additional terms and conditions apply.

Appendix 3

Excerpts from the FCC's Cost Accounting Rules

Code of Federal Regulations
Title 47, Volume 2
From the U.S. Government Printing Office via GPO Access

Part 32 - Uniform System Of Accounts For Telecommunications Companies

Sec. 32.23 Nonregulated activities.

(a) This section describes the accounting treatment of activities classified for accounting purposes as ``nonregulated." Preemptively deregulated activities and activities (other than incidental activities) never subject to regulation will be classified for accounting purposes as ``nonregulated." Activities that qualify for incidental treatment under the policies of this Commission will be classified for accounting purposes as regulated activities. Activities that have been deregulated by a state will be classified for accounting purposes as regulated activities. Activities that have been deregulated at the interstate level, but not preemptively deregulated, will be classified for accounting purposes as regulated activities until such time as this Commission decides otherwise. The treatment of nonregulated activities shall differ depending on the extent of the common or joint use of assets and resources in the provision of both regulated and nonregulated products and services.

(b) When a nonregulated activity does not involve the joint or common use of assets and resources in the provision of both regulated and nonregulated products and services, carriers shall account for these activities on a separate set of books consistent with instructions set forth in Sec. Sec. 32.1406 and 32.7990. Transfers of assets, and sales of products and services between the regulated activity and a nonregulated activity for which a separate set of books is maintained, shall be accounted for in accordance with the rules presented in Sec. 32.27, Transactions with Affiliates. In the separate set of books, carriers may establish whatever detail they deem appropriate beyond what is necessary to provide this Commission with the information required in Sec. Sec. 32.1406 and 32.7990.

(c) When a nonregulated activity does involve the joint or common use of assets and resources in the provision of regulated and nonregulated products and services, carriers shall account for these activities within accounts prescribed in this system for telephone company operations. Assets and expenses shall be subdivided in subsidiary records among amounts solely assignable to nonregulated activities, amounts solely assignable to regulated activities, and amounts related to assets and expenses incurred jointly or in common, which will be allocated between regulated and nonregulated activities. Carriers shall submit reports identifying regulated and nonregulated amounts in the manner and at the times prescribed by this Commission. Nonregulated revenue items not qualifying for incidental treatment as provided in Sec. 32.4999(l) of this part, shall be recorded in separate subsidiary record categories of Account 5280, Nonregulated operating revenue. Amounts assigned or allocated to regulated products or services shall be subject to part 36 of this chapter.

Sec. 32.27 Transactions with affiliates.

(a) Unless otherwise approved by the Chief, Wireline Competition Bureau, transactions with affiliates involving asset transfers into or out of the regulated accounts shall be recorded by the carrier in its regulated accounts as provided in paragraphs (b) through (f) of this section.

(b) Assets sold or transferred between a carrier and its affiliate pursuant to a tariff, including a tariff filed with a state commission, shall be recorded in the appropriate revenue accounts at the tariffed rate. Non-tariffed assets sold or transferred between a carrier and its affiliate that qualify for prevailing price valuation, as defined in paragraph (d) of this section, shall be recorded at the prevailing price. For all other assets sold by or transferred from a carrier to its affiliate, the assets shall be recorded at no less than the higher of fair market value and net book cost. For all other assets sold by or transferred to a carrier from its affiliate, the assets shall be recorded at no more than the lower of fair market value and net book cost.

(1) Floor. When assets are sold by or transferred from a carrier to an affiliate, the higher of fair market value and net book cost establishes a floor, below which the transaction cannot be recorded. Carriers may record the transaction at an amount equal to or greater than the floor, so long as that action complies with the Communications Act of 1934, as amended, Commission rules and orders, and is not otherwise anti-competitive.

(2) Ceiling. When assets are purchased from or transferred from an affiliate to a carrier, the lower of fair market value and net book cost establishes a ceiling, above which the transaction cannot be recorded. Carriers may record the transaction at an amount equal to or less than the ceiling, so long as that action complies with the Communications Act of 1934, as amended, Commission rules and orders, and is not otherwise anti-competitive.

(3) Threshold. For purposes of this section carriers are required to make a good faith determination of fair market value for an asset when the total aggregate annual value of the asset(s) reaches or exceeds $500,000, per affiliate. When a carrier reaches or exceeds the $500,000 threshold for a particular asset for the first time, the carrier must perform the market valuation and value the transaction on a going- forward basis in accordance with the affiliate transactions rules on a going-forward basis. When the total aggregate annual value of the asset(s) does not reach or exceed $500,000, the asset(s) shall be recorded at net book cost.

(c) Services provided between a carrier and its affiliate pursuant to a tariff, including a tariff filed with a state commission, shall be recorded in the appropriate revenue accounts at the tariffed rate. Non- tariffed services provided between a carrier and its affiliate pursuant to publicly-filed agreements submitted to a state commission pursuant to section 252(e) of the Communications Act of 1934 or statements of generally available terms pursuant to section 252(f) shall be recorded using the charges appearing in such publicly-filed agreements or statements. Non-tariffed services provided between a carrier and its affiliate that qualify for prevailing price valuation, as defined in paragraph (d) of this section, shall be recorded at the prevailing price. For all other services sold by or transferred from a carrier to its affiliate, the services shall be recorded at no less than the higher of fair market value and fully distributed cost. For all other services sold by or transferred to a carrier from its affiliate, the services shall be recorded at no more than the lower of fair market value and fully distributed cost.

(1) Floor. When services are sold by or transferred from a carrier to an affiliate, the higher of fair market value and fully distributed cost establishes a floor, below which the transaction cannot be recorded. Carriers may record the transaction at an amount equal to or greater than the floor, so long as that action complies with the Communications Act of 1934, as amended, Commission rules and orders, and is not otherwise anti-competitive.

(2) Ceiling. When services are purchased from or transferred from an affiliate to a carrier, the lower of fair market value and fully distributed cost establishes a ceiling, above which the transaction cannot be recorded. Carriers may record the transaction at an amount equal to or less than the ceiling, so long as that action complies with the Communications Act of 1934, as amended, Commission rules and orders, and is not otherwise anti-competitive.

(3) Threshold. For purposes of this section, carriers are required to make a good faith determination of fair market value for a service when the total aggregate annual value of that service reaches or exceeds $500,000, per affiliate. When a carrier reaches or exceeds the $500,000 threshold for a particular service for the first time, the carrier must perform the market valuation and value the transaction in accordance with the affiliate transactions rules on a going-forward basis. All services received by a carrier from its affiliate(s) that exist solely to provide services to members of the carrier's corporate family shall be recorded at fully distributed cost.

(d) In order to qualify for prevailing price valuation in paragraphs (b) and (c) of this section, sales of a particular asset or service to third parties must encompass greater than 25 percent of the total quantity of such product or service sold by an entity. Carriers shall apply this 25 percent threshold on an asset-by-asset and service-by- service basis, rather than on a product-line or service-line basis. In the case of transactions for assets and services subject to section 272, a BOC may record such transactions at prevailing price regardless of whether the 25 percent threshold has been satisfied.

(e) Income taxes shall be allocated among the regulated activities of the carrier, its nonregulated divisions, and members of an affiliated group. Under circumstances in which income taxes are determined on a consolidated basis by the carrier and other members of the affiliated group, the income tax expense to be recorded by the carrier shall be the same as would result if determined for the carrier separately for all time periods, except that the tax effect of carry-back and carry-forward operating losses, investment tax credits, or other tax credits generated by operations of the carrier shall be recorded by the carrier during the period in which applied in settlement of the taxes otherwise attributable to any member, or combination of members, of the affiliated group.

(f) Companies that employ average schedules in lieu of actual costs are exempt from the provisions of this section. For other organizations, the principles set forth in this section shall apply equally to corporations, proprietorships, partnerships and other forms of business organizations.

Part 64 - Miscellaneous Rules Relating To Common Carriers

Sec. 64.901 Allocation of costs.

(a) Carriers required to separate their regulated costs from nonregulated costs shall use the attributable cost method of cost allocation for such purpose.

(b) In assigning or allocating costs to regulated and nonregulated activities, carriers shall follow the principles described herein.

(1) Tariffed services provided to a nonregulated activity will be charged to the nonregulated activity at the tariffed rates and credited to the regulated revenue account for that service. Nontariffed services, offered pursuant to a section 252(e) agreement, provided to a nonregulated activity will be charged to the nonregulated activity at the amount set forth in the applicable interconnection agreement approved by a state commission pursuant to section 252(e) and credited to the regulated revenue account for that service.

(2) Costs shall be directly assigned to either regulated or nonregulated activities whenever possible.

(3) Costs which cannot be directly assigned to either regulated or nonregulated activities will be described as common costs. Common costs shall be grouped into homogeneous cost categories designed to facilitate the proper allocation of costs between a carrier's regulated and nonregulated activities. Each cost category shall be allocated between regulated and nonregulated activities in accordance with the following hierarchy:

(i) Whenever possible, common cost categories are to be allocated based upon direct analysis of the origin of the cost themselves.

(ii) When direct analysis is not possible, common cost categories shall be allocated based upon an indirect, cost-causative linkage to another cost category (or group of cost categories) for which a direct assignment or allocation is available.

(iii) When neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities.

(4) The allocation of central office equipment and outside plant investment costs between regulated and nonregulated activities shall be based upon the relative regulated and nonregulated usage of the investment during the calendar year when nonregulated usage is greatest in comparison to regulated usage during the three calendar years beginning with the calendar year during which the investment usage forecast is filed.

(c) A telecommunications carrier may not use services that are not competitive to subsidize services subject to competition. Services included in the definition of universal service shall bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.

Sec. 64.902 Transactions with affiliates.

Except for carriers which employ average schedules in lieu of determining their costs, all carriers subject to Sec. 64.901 are also subject to the provisions of Sec. 32.27 of this chapter concerning transactions with affiliates.

Sec. 64.903 Cost allocation manuals.

(a) Each incumbent local exchange carrier having annual revenues from regulated telecommunications operations that are equal to or above the indexed revenue threshold (as defined in Sec. 32.9000 of this chapter) except mid-sized incumbent local exchange carriers is required to file a cost allocation manual describing how it separates regulated from nonregulated costs. The manual shall contain the following information regarding the carrier's allocation of costs between regulated and nonregulated activities:

(1) A description of each of the carrier's nonregulated activities;

(2) A list of all the activities to which the carrier now accords incidental accounting treatment and the justification therefor;

(3) A chart showing all of the carrier's corporate affiliates;

(4) A statement identifying each affiliate that engages in or will engage in transactions with the carrier and describing the nature, terms and frequency of each transaction;

(5) A cost apportionment table showing, for each account containing costs incurred in providing regulated services, the cost pools with that account, the procedures used to place costs into each cost pool, and the method used to apportion the costs within each cost pool between regulated and nonregulated activities; and

(6) A description of the time reporting procedures that the carrier uses, including the methods or studies designed to measure and allocate non-productive time.

(b) Each carrier shall ensure that the information contained in its cost allocation manual is accurate. Carriers must update their cost allocation manuals at least annually, except that changes to the cost apportionment table and to the description of time reporting procedures must be filed at the time of implementation. Annual cost allocation manual updates shall be filed on or before the last working day of each calendar year. Proposed changes in the description of time reporting procedures, the statement concerning affiliate transactions, and the cost apportionment table must be accompanied by a statement quantifying the impact of each change on regulated operations. Changes in the description of time reporting procedures and the statement concerning affiliate transactions must be quantified in $100,000 increments at the account level. Changes in cost apportionment tables must be quantified in $100,000 increments at the cost pool level. The Chief, Wireline Competition Bureau may suspend any such changes for a period not to exceed 180 days, and may thereafter allow the change to become effective or prescribe a different procedure.

(c) The Commission may by order require any other communications common carrier to file and maintain a cost allocation manual as provided in this section.

Sec. 64.904 Independent audits.

(a) Each carrier required to file a cost allocation manual shall elect to either have an attest engagement performed by an independent auditor every two years, covering the prior two year period, or have a financial audit performed by an independent auditor every two years, covering the prior two year period. In either case, the initial engagement shall be performed in the calendar year after the carrier is first required to file a cost allocation manual.

(b) The attest engagement shall be an examination engagement and shall provide a written communication that expresses an opinion that the systems, processes, and procedures applied by the carrier to generate the results reported pursuant to Sec. 43.21(e)(2) of this chapter comply with the Commission's Joint Cost Orders issued in conjunction with CC Docket No. 86-111, the Commission's Accounting Safeguards proceeding in CC Docket No. 96-150, and the Commission's rules and regulations including Sec. Sec. 32.23 and 32.27 of this chapter, and Sec. 64.901, and Sec. 64.903 in force as of the date of the auditor's report. At least 30 days prior to beginning the attestation engagement, the independent auditors shall provide the Commission with the audit program. The attest engagement shall be conducted in accordance with the attestation standards established by the American Institute of Certified Public Accountants, except as otherwise directed by the Chief, Enforcement Bureau.

(c) The biennial financial audit shall provide a positive opinion on whether the applicable date shown in the carrier's annual report required by Sec. 43.21(e)(2) of this chapter present fairly, in all material respects, the information of the Commission's Joint Cost Orders issued in conjunction with CC Docket No. 86-111, the Commission's Accounting Safeguards proceeding in CC Docket No. 96-150, and the Commission's rules and regulations including Sec. Sec. 32.23 and 32.27 of this chapter, and Sec. 64.901, and Sec. 64.903 in force as of the date of the auditor's report. The audit shall be conducted in accordance with generally accepted auditing standards, except as otherwise directed by the Chief, Enforcement Bureau. The report of the independent auditor shall be filed at the time that the carrier files the annual reports required by Sec. 43.21(e)(2) of this chapter.